# The Journal of Social, Political and Economic Studies

Fall, 1995 Vol. 20, No. 3

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# The Journal of SOCIAL, POLITICAL AND ECONOMIC STUDIES

Roger Pearson
*General Editor*
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*Associate Editor*

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# The Economic Crisis of the First World[1]

**Anthony Harrigan**
*Counselor, U. S. Business and Industrial Council Educational Foundation*

When the Soviet Union imploded, the nations of the First World – the United States among them – envisioned smooth sailing into the 21st century. There was much talk of a huge "peace dividend." This optimistic vision of what lay ahead has been severely eroded, if not shattered, by a variety of developments, including strife in Bosnia, Somalia, Haiti, and even within the Russian Federation. At the same time, there have been ominous economic problems, conflicts and challenges – the near economic wars, the on-going economic deterioration of Africa, crushing economic problems within the former Soviet Union, the economic stagnation of much of Western Europe, the Mexican debt crisis, high unemployment in Britain, France, and other allied nations, and deindustrialization and underemployment in the United States.

Indeed there are several crises facing the First World, including a moral crisis and a threatening crisis with rogue states with ambitious military agendas that aim at becoming nuclear-armed states. However, in this paper let us consider the economic crisis that in which the First World finds itself. In the United States, tremendous attention is devoted to economic issues, to topical issues, that is – tax and interest rates, housing starts, and similar matters. And a superficial prosperity in the United States causes us to divert attention from the long-range, deeper problems and threats. It is important to remember that in 1928 economists, and political and business leaders, didn't consider the possibility that America was on the brink of an economic collapse that would produce a deep depression until America entered World War II. Have we a clearer vision today?

---

[1] Editor's note: This article was first published in *Vital Speeches of the Day* (July 1, 1995), having been delivered by Dr. Harrigan at the Institute for the Study of Economic and Political Freedom of the University of Colorado on June 11, 1995. While the author is speaking of Americans and their interests, he makes it clear that he considers his remarks to apply equally to the peoples and nations of Europe.



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Here and there one finds students of the world economy who warn of another enormous economic crisis with grim implications for First World societies and political institutions. One of these far-sighted economic observers is Sir James Goldsmith, the Franco-British financier. Two years ago, he began to voice ominous warnings. He said that in the case of Western Europe, with some 20 percent unemployed, "the critical mass is here for implosion and social upheaval and political instability on a global scale." He predicted that the Bolshevik revolution of 1917 will pale into insignificance when compared to this upheaval. And the situation in Western Europe has worsened since he issued that warning.

Now the United States hasn't this kind of unemployment problem, except in its inner cities. The overall unemployment rate for the nation as a whole has risen a bit, but *under*employment has risen on a colossal scale. Millions of Americans have jobs that don't provide sufficient income to support a family – even with husband and wife working. And many of these millions don't have the benefits associated with the good jobs that existed in the decades after World War II.

Dr. Edward M. Lutwak of the Center for Strategic and International Studies in Washington has analyzed this problem. Dr. Lutwak has observed:

> The problem in question is the unprecedented sense of personal economic insecurity that has rather suddenly become the central phenomenon of life in America, not only for the notoriously endangered species of corporate middle managers, prime targets of today's fashionable downsizing and re-engineering, but for virtually all working Americans except tenured civil servants – whose security is duly resented.

The reasons for the economic insecurity felt by millions of Americans are numerous and complex. A key element is exploding technology which has made many jobs as out-of-date as buggy-making. And this has made much employment temporary in nature, thereby endangering working people and their families who don't have advanced technical skills or the education to obtain such. But there are other powerful forces at work: and these forces have a tremendous bearing on Europeans as well as Americans. These



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forces cause the displacement of European and American-made goods, wipe out jobs on both sides of the Atlantic, and produce the most terrible anxieties, as well as threatening, as Kevin Phillips has written, to cause the near descent of Europe and North America into Third World status.

It is important to reflect on the words of Sir James Goldsmith. In an article published in *The Washington Times*, November 27, 1994, Sir James said:

> During the past few years 4 billion people have suddenly entered the world economy. They include the populations of China, India, Vietnam, Bangladesh and the countries that were part of the Soviet empire, among others. These populations are growing fast. In 35 years, that 4 billion is forecast to expand to more than 6.5 billion. The nations where those 4 billion live have very high levels of unemployment and those people who do find jobs offer their labor for a tiny fraction of the pay earned by workers in the developed world. That means that new entrants into the world economy are in direct competition with the work forces of developed countries.

This is a situation unprecedented in the history of the older industrial countries. China, for example, is directed in large measure at capturing the domestic markets of the Western countries and, thereby, acquiring hard Western currencies for their own purposes – for a massive military buildup in the case of China. Simultaneously, therefore, the Western countries are losing their internal markets on which their peoples depend and are financing new foreign military challenges. Europeans, chiefly the French, are increasingly mindful of this threat. But the United States is fixated on Third World countries as trading partners, not as a developing military threat. This kind of fixation is nothing new. Fifteen years ago, the great business interests of the United States were desperate and determined to sell the most advanced technological equipment to the Soviet Union – products such as super-computers and ball bearings for missile installations.

Blindness to the Crisis of the First World could cause us to descend precipitously along the road to instability and collapse. Sir James Goldsmith is not alone in sounding the alarm. There are other keen observers of the world scene who share Sir James's concerns.



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One of these is Arnaud de Borchgrave, the Belgian-born writer and editor, who has written in warning:

> By putting one's ear to the rail, one can hear the distant rumble of social upheaval...
>
> Jobs are a global crisis. The 24 Organization for Economic Cooperation and Development nations – the world's wealthiest – now have a mind-numbing 35 million on the dole...
>
> No one knows what the critical mass of unemployment is.
>
> But when the legions of Europe out of work realize that no one seems to have an answer to the shed-jobs-to-cut-costs dilemma, the ingredients for a continent-wide social explosion will be in place. This is now known as the unacceptable force of capitalism.

He reported that 50 percent of Europe's unemployed have been made to feel unwanted for a year or longer.

In Europe there is anger and unrest associated with the unemployment. If one reads the London *Financial Times*, one gets an idea of the severity of the problems from Spain to Ireland and from Italy to Scandinavia. As European jobs are exported to Asia (one-third of Europe's steel comes from the Far East), powerful populist movements are growing – movements which insist on national identity, control of national borders against a flood of migrants and imported goods. These movements are strenuously opposed to what they see as economic and cultural homogenization which would level incomes worldwide for the benefit of financial interests.

On neither side of the Atlantic is there sufficient appreciation of the growing anger. And most commentators blithely ignore the problem. They look at the underlying economic problem in strictly economic terms, dismissing the human dimension. For example, an editor of *Kiplinger's Letter* has asserted that the U.S. is reindustrializing, not deindustrializing, observing that U.S. factories are producing goods more efficiently – more goods with fewer people. But that's precisely the point. Scores of thousands have been thrown out of work in the name of efficiency and global competition. The economic commentators are thinking of society in terms of the cost-price ratio, not in terms of people.

Part of the problem is that so many economic commentators



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persist in employing euphemisms for very serious societal problems. One of the favorite euphemisms is "rationalizing" of business. This is how an important British press voice referred to the layoff of 6,500 workers by the Rolls-Royce company in Scotland. It is doubtful that it makes a worker and his family happier or more accepting if he is told that his livelihood is being "rationalized" out of existence, especially if the work is being shifted to Malaysia or another Far Eastern country. The Rolls-Royce announcement was greeted with "anger and dismay in Scotland." At the time of the Kobe earthquake, it was noted that among the damaged facilities was Caterpillar's tractor factory. The jobs at Kobe had been exported from Peoria, Illinois. "Downsizing" is another euphemism. In the last few years, IBM, Xerox, and many other industrial giants have been downsized, with scores of thousands of highly skilled workers – blue collar, white collar, and managerial – laid off. What's happening, in fact, is that the United States is being downsized. For generations, young Americans have been taught the virtues of self-sufficiency, hard work, cooperation, and loyalty. But these virtues are dismissed in an era of "rationalization" and "downsizing." They don't prevent giant enterprises from shipping jobs abroad. And national legislators seem blind to the problem or to the growing public anger at the abandonment of hard-working citizens, the type who made America.

E. F. McLaughlin has reported in *The Washington Post* that employment by America's Fortune 500 companies fell from 16 to fewer than 12 million in 1992. The job loss among smaller manufacturers has been equally severe.

More and more production is being shifted overseas. *The New York Times* reported on August 25, 1995, that there has been "explosive growth" in the number of Indian computer scientists working for American companies. They are paid a fraction of what Americans receive. Texas Instruments, for example, has a plant in Bangalore, India, for computer chip design operations. Jack Beatty of *The Atlantic* cites the devastating impact of offshore production on the American middle class. Social values – job and family security – are being sacrificed for higher profits by shareholders, and the economic interest of the few is being accorded a higher value than the stability of American society. Fewer and fewer Americans are covered by company pensions. Longterm employment is on the decline. Large corporations are trying to slough off scores of



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thousands of employees. Labor analyst Harold Meyereson wrote in the *L. A. Weekly* that "the American economy's response to the globalization of markets has been to turn us into a nation of temps." The process is also at work in Europe. Daimler-Benz, Germany's largest company, is planning to shed a quarter of its work force. Philip Stephens, columnist for *The Financial Times* in London, recently wrote of the insecurity phenomenon, saying that "the middle class lifeplan has been tossed aside by the cold winds of global competition. Middle class people are being faced with short-term contracts instead of lifetime guarantees."

Euphemisms in the economic areas mask deeply disturbing phenomena. The March 31 issue of *Forward* pointed this out with great clarity. A column in that newspaper noted:

> If an American company closes a plant here and ships its equipment to China, that will be called an 'export.' It will be an 'export' that will not add, but will subtract, jobs from America.
>
> Another case: Component parts from America will be shipped to Mexico, to be assembled there and sold exclusively, by law, in America. The shipments in Mexico will be listed as an 'export,' although nothing was exported except American jobs that once assembled the product here.
>
> Or another case: Component parts for a dishwasher or a car are imported from Third World countries. The labor in the parts makes up 80 percent of the labor in the completed product. When sold to the elite of some Third World country, the value of the finished product is listed as an 'export.'
>
> And so we list as exports the export of jobs, the export of products we imported, the export of products that are never sold to another country. We figment these 'exports' to fictitious 'emerging markets' to conceal the fact that we are moving jobs out of America to other countries where manufacturers are using cheap – often child and slave – labor to make things, carrying the labels of American companies, to be sold in America.

The failure of mainstream European leaders to understand this anger is leading to political fragmentation. There is evidence of a growing divide in Europe. The *Financial Times* says this was reflected in the vote on the Maastricht Treaty, with the professional middle class in favor and "two thirds of working people against it." The glue



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that held together the center-right parties is dissolving, in large part "under the impact of European integration and the worldwide move towards free trade," said the *Times*. The opponents of globalism and economic homogenization surely will become a powerful force on both sides of the Atlantic. The Perot movement of 1992 was an indicator of coming change. Much of the Perot message had to do with betrayal of the economic interests of ordinary Americans, those whom a writer for *Fortune* magazine (February 1995) referred to as "the have-less half of the middle class." The political explosiveness of the situation a few years hence should be apparent to every thoughtful citizen. Imagine the anger of a 45-year-old middle manager who has been "restructured" out of his job and the ability to pay his mortgage, make his car payments or send his children to college.

Americans and Europeans soon may begin to understand the price of the transnational "free market," the globalist vision of those who are contemptuous of the losers in their countries' populations and who seek the protection of the nations where they are headquartered but who disavow any responsibility to the interests of their nations. Where this leads one can't predict, but one recognizes a loss of living standard expectations on the part of many millions who are squeezed out in the game of globalist competition. These are citizens who are shoved to the margins, irrespective of the promises of Western democratic government. The prospects are dismal for many Americans and Europeans even as some elements in their nations profit enormously from globalism. In our time, greed overwhelms patriotism, as evidenced in the opposition to trade policies which would safeguard the economic well-being of millions of ordinary Americans who have lost or will lose their jobs.

Something is very wrong when a company decides to maintain only its head office and, possibly, its sale force in its home country, and transfers production to low-wage countries. I submit it's immoral to eliminate one's national work force and transfer production abroad. The argument has been that the losses will be made up in advanced products. But, as Sir James Goldsmith has noted, when the French signed a $2.1 billion contract with South Korea for high-speed trains, it produced only 800 jobs in France. More and more aircraft contracts with Asian countries mean shifting large parts of the production process to those countries. The believers in the theology



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of total free trade seek a worldwide market in goods, services, capital, and yes, labor. That means the hollowing out of American manufacturing enterprises. It means that U.S. workers have to compete with Chinese workers who earn twenty cents an hour.

The focus of the major financial interests is not on the United States, the American economy, or the needs of the American people. Indicative of this lack of focus, of an alternative focus, was a symposium held in May 1995 in China under the auspices of the *International Herald Tribune*, which is jointly owned by *The New York Times* and *The Washington Post*. The paper, to use its language, invited to China a "limited number of the largest multinational corporations with a stake in the future of the Chinese economy." It would be interesting to know the names of these multinational corporations, which are headquartered in the United States, where their investments are being made, and especially, how much is being invested in China and other Asian countries and how much in the U.S. Finally, what percentage of their goods manufactured abroad is sold in the American market? This is information that the American people need to know, which Congress is not trying to obtain for them.

The American people have paid a hellish price for this focus on the economic future of countries such as China, which are earning huge profits from penetrating the U.S. domestic market in order to challenge the United States. The price is not only in lost American jobs but stagnated communities, deteriorated wages, the drying up of small businesses, and dependence on export markets, meaning dependence on foreign regimes and their financial maneuvers. The greatest loss, of course, is America's economic sovereignty.

Those who defend globalization, despite these losses, argue that the United States can more than make up for them by training unskilled workers. But this training is not the answer to the problem of unemployment in Europe, or unemployment in the United States – the proliferation, that is, of jobs that don't pay enough to provide even a minimal standard of living. Even *The Economist* magazine, which is an ardent supporter of globalization, recognizes that "wages at the bottom are lower in America" than in Europe. And it admits that "training can even be the royal road to ruin." Those interested in so-called "rationalizing" of jobs can gain more advantage by eliminating jobs where there is demarcating of jobs based on skills rather than establishing frequent, costly job-training programs. And



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the presentation of job-training as the magic bullet ignores the fact that employers prefer younger, supposedly more flexible workers than middle-aged workers who have lost their jobs through corporate "downsizing." In any case, what are so-called redundant workers to be trained for? America's global competitors aren't without skilled workers or brains.

It is politically fashionable to speak of "empowering" Americans, meaning restoring them to a condition of individual responsibility and local control – both worthy objectives. But the most important empowerment involves the restoration of their family values, moral values in the public environment, and economic empowerment. Over 15 years, they have lost economic power enjoyed by previous generations of Americans.

There are many who profess to believe in democratic principles and a moral approach to the organization of American society but who show disdain for the ordinary American. An example of this was an article by *Washington Post* columnist Richard Cohen (February 2, 1995) in which he lambasted popular opposition to the $40 billion Mexican bailout. He declared that the people "aren't always wise." To be sure, it was their money, their credit, that was on the line. And so it is with the grand globalist economic schemes. That ordinary Americans suffer in the process seems to be of little concern to those who predict vast opportunities in so-called emerging markets such as China. But there's no reason to believe that the American people, apart from Wall Street investors, stand to benefit from a $30 billion trade deficit with China.

The dark scenario I present here is not simply one person's vision. A Shell International Petroleum Co. economist, Peter Kassler, has presented a scenario called "Barricades" which envisions social and economic chaos under the GATT trade regime, with unrelenting job cuts and downward pressure on wages in industrial countries. *Business Week* (December 19, 1994) said that "potent opposition is growing against the politicians who would further weaken a nation's power to set its economic course."

It reported on the so-called "anxious class" on both sides of the Atlantic, noting that in Britain wages are stagnating and that nearly 90 percent of new jobs in the U.K. are part-time. In France, Sir James Goldsmith says, hard-nosed corporations press for lower wages at home or "rush to the Third World to exploit cheap labor."



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The conditions described here constitute the so-called New World Order, the transnational world order. This New World Order already has played havoc with the lives of millions of Americans and Europeans. The existence of a $150 billion trade deficit with Asia – for the United States, that is – is a feature of the New World Order and derives from the economic priorities of those who favor the transnational outlook. But this New World Order may go the way of other new world orders in the 20th century – the socialist, communist, and Nazi new world orders. And the struggle over the latest New World Order will focus on a variety of questions, involving what one writer (*Washington Post*, January 29, 1995) referred to as "intertwining forms of governance, ideology, cultural life, and the protection and distribution of goods" – and, I would add, morality.

As a civilization on both sides of the Atlantic, the First World has not found its way through this thicket of issues, forces, and problems. I suspect that it hasn't a great deal of time to repair the fabric of its civilization and also meet the economic challenges it faces, as well as deal with the internal stresses and anxieties – and anger – provoked by economic policies and tendencies. *Business Week*, a certifiable establishment journal, asserted (December 19, 1994) that if the U.S. doesn't find a way, "There could be hell to pay," a logical conclusion. If Americans and Europeans, the working people, don't get the rewards they believe they deserve, that their countries' striving over generations seemed to ensure, the result will be strife – revolution, that is, in one form or another. The anxiety level is rising, and if the standard of living is whittled away by runaway globalist policies, the backlash will be like nothing we have seen in the post-World War II history of the North Atlantic nations. What form it will take is unclear at this time. But it surely will occur. Precisely how the economic crisis will impact society in moral terms also remains in the realm of the unknown. One thing is certain: the peoples of the West will not simply accommodate themselves to diminished expectations and diminished results. And there will be a massive vote of no-confidence in the political and cultural leadership elites in the West who have steered us into decline, or who have been indifferent to the dangers and tolerated decline.

Dr. Winifred McClay, an historian at Tulane University, has written that need exists for a "consolidated or nationalized political and economic order." Such an order would overcome the



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establishment notion that national sovereignty and economic independence are things of the past. It would put public policy in a new moral framework, a framework of respect for all Americans and American interests. How does America achieve a new nationalist, as opposed to a globalist, economic policy? The answer could be the subject of many lectures. But I submit that the essential first step is to defang the transnational multinational companies, the money power that increasingly holds the First World in thrall. And how docan it go about defanging them? By restricting their operations, placing limits on those who are headquartered in the nations of the First World and seek the protection of those nations while rejecting any special loyalty to them. If they shift their manufacturing operations to low-wage Third World countries in order to sell their slave-wage-made goods in the American market, then let them be subject to penalties. In other words, strike at their profits. And the foreign-headquartered multinationals would be subjected to the same barriers employed by the Japanese when the latter protect their national economic interest. There is nothing radical about such an approach. It is what the U.S. supported when the Sherman Anti-Trust Act was written into law to block the operations of the monopolistic domestic cartels of the late 19th century. And I submit that the new policies of limitation would have the same moral purpose as the Sherman Act, which was passed to protect ordinary Americans from exploitation.

As a traditional conservative I regard problems of moral decline and economic threat as two faces of the same coin. I believe that in recent years, as a result of the emergence and power of the transnational corporations and the transnational globalist international organizations, the U.S. has departed from the ways prescribed by the U.S. Constitution and from the moral instructions as evidenced in the Preamble to the Constitution with its dedication of the U.S. system of government to the promotion of the general welfare. The U.S. needs a new emphasis upon virtue, authentic justice, recognition of shared experience and shared devotion to the common good – all that America is about, as the Founding Fathers ordained in the Constitution. And as a traditional conservative, who fears a post-constitutional America, I look for wisdom and understanding wherever I can find it – even in what may seem the most unlikely sources. I found evidence of it in a statement by



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former Gov. Jerry Brown of California, not someone I have quoted favorably before. Interviewed by *Chronicles* magazine, a conservative intellectual journal, he said that the U.S. needs

> enrichment of the community and real deconstruction of the workings of the global economy, global institutions – the central banks, the General Agreement on Tariffs and Trade, the World Bank, the multinational companies – and of the way in which our lives are being embedded in a runaway, large-scale corporate, global culture that is undemocratic, inhuman, and destructive.

What he said of the U.S. is true of the First World generally. The late Russell Kirk, the great conservative thinker, could have written these words. They are in the spirit of Edmund Burke and the Founding Fathers of America, and they provide the goals for the moral recovery, community strengthening, and economic safeguarding of the nations of the First World generally. If America and the other Western nations embrace this understanding, adopt this new direction for their national affairs, and wake to the need for a restoration of the moral virtue that characterized their civilization in the past, they should be able to overcome all the challenges we have entioned and reinvigorate the public and private order built upon the priceless heritage of the Western world.



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# The Changing Economic And Political Environment In The Gulf Monarchies[1]

Gawdat Bahgat
*Department of Political Science*
*Indiana University of Pennsylvania*

For the last few decades the Gulf region has enjoyed an increasing strategic significance due to its growing share of world oil production and export. Moreover, two-thirds of the world's oil reserves are located in the Gulf. Thus, it is fair to state that the prosperity of world economy depends, to a great extent, on the regional security and political stability of the Gulf region.

Since independence, Gulf regimes have based their legitimacy on tribal heritage, religious appeal, family power, and abundant oil wealth. Tribes play the role of political parties and the distribution of socio-economic and political power reflects the relative weight of each tribe. Islam is the official religion in all the Gulf states and Sharia'a (Islamic law) is the basis of their legal systems. Most of the royal families have dominated their societies for a long time[2] and still hold the main positions in their systems including the head of state, crown prince, prime minister, as well as the main portfolios such as defense, foreign affairs and interior. Finally oil shocks in 1973, the Arab-Israeli war, and in 1979, the Iranian Revolution, put enormous wealth in the hands of the Gulf rulers.

This equilibrium provided Gulf regimes with a high level of stability in most of the 1970s and 1980s. However, beginning by the early 1990 these rules of the political process have been under pressure. There are growing signs of popular dissent. This diminishing consensus has not taken the shape of violent revolution, rather it has been embodied in a number of petitions signed by religious leaders

[1] The author wishes to acknowledge the support he received from Michele Reynold and Monte Palmer.

[2] For a detailed history of these royal families see Gawdat Bahgat., "Regional Peace and Stability in the Gulf." *Security Dialogue*, vol.26, no.3, September 1995, p.86.



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and intellectuals demanding more accountability. Gulf governments, on the other side, responded by a combination of accommodation and repression: creating consultative councils and arresting those who went too far in opposing their rules.

To sum up, the economic and political environments in the Gulf in the mid 1990s look different from what they were a decade or two ago. This study focuses on one aspect for this change, oil wealth. It proposes that the decline of Gulf states' financial resources, among other things, has eroded the political formula of the 1970s and 1980s. The collapse of oil prices since the mid 1980s as well as the rise of military expenditures in response to regional threats have contributed to this decline. In an attempt to create a new consensus and to form a new social contract the governments have introduced a number of measures to liberalize their economic and political systems. This study examines the nature, magnitude, and direction of this reform as well as the forces which will shape it in the near future in the six Gulf monarchies (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates.)

**The Changing Economic Environment**

Oil is the largest source of public revenue and the biggest component of the gross domestic product (GDP) for each of the Gulf monarchies. Not surprisingly the economic and political systems in the region have been subject to the fluctuation of oil prices over the last three decades. For many years oil prices have been stable at a low level. However, Oil was used as a political weapon during and in the aftermath of the Arab-Israeli War of 1973 in what came to be known as 'oil shock.' The Iranian Revolution in 1979 was an important cause for the second oil shock. Following these two events oil prices skyrocketed as the following table shows,

The huge oil wealth in the 1970a and early 1980s gave Gulf governments a significant economic leverage. They were able to provide their citizens with a vast array of services and benefits at little or no cost in what came to be known as a rentier state[3] or a pre-

[3] For an extensive discussion for the concept "rentier" see Hazem Beblawi and Giacomo Luciani., (Eds) The Rentier State. London: Croom Helm, 1987, and for a more recent analysis see Giacomo Luciani., "The Oil Rent, the Fiscal Crisis of the State and Democratization" in Ghassan Salame., Democracy without Democrats? London: I.B. Tauris



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**Table I**
**Oil Prices in U.S. dollars per barrel (1972-1994)**

| *Year* | *$* | *Year* | *$* | *Year* | *$* |
|---|---|---|---|---|---|
| 1972 | 01.90 | 1980 | 35.69 | 1988 | 13.22 |
| 73 | 02.83 | 81 | 34.32 | 89 | 15.69 |
| 74 | 10.41 | 82 | 31.80 | 90 | 20.50 |
| 75 | 10.70 | 83 | 28.78 | 91 | 16.56 |
| 76 | 11.63 | 84 | 28.07 | 92 | 17.21 |
| 77 | 12.38 | 85 | 27.53 | 93 | 14.90 |
| 78 | 13.03 | 86 | 12.97 | 94 | 14.76 |
| *79* | *29.75* | *87* | *16.92* | | |

Source: British Petroleum., BP Statistical Review of World Energy. London: British Petroleum Company, June 1995, p.12.

**Table II**
**Gulf Monarchies' External Debt in million of U.S. dollars (1993-1995)**

| *Country* | *1993* | *94* | **95* |
|---|---|---|---|
| Bahrain | 00,054.0 | 00,052.0 | 00,056.0 |
| Kuwait | 08,768.0 | 09,432.0 | 08,550.0 |
| Oman | 00,166.8 | 00,181.2 | 00,168.8 |
| Qatar | 02,000.0 | 03,950.0 | 05,000.0 |
| Saudi Arabia | 20,000.0 | 28,978.0 | 32,178.0 |
| *UAE* | *09,700.0* | *10,100.0* | *10,100.0* |

Source: Middle East Economic Digest., "Annual Review," vol, 38, no.51, December 23, 1994, pp.23, 28, 31, 34, 39.

* Figures for 1995 are MEED estimates.

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Publishers, 1994, pp.130-154.



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industrial, non-extractive welfare state[4]. However, by the mid 1980s, as the table suggests, oil prices collapsed. Even worse, taking into account the declining value of the American dollar, in which oil sales are denominated, the purchasing power of the average barrel of oil has dropped from a base of 100 in 1985 to 32.42 in 1995[5].

Consequently, all the six Gulf monarchies have been running considerable budget deficit for most of the past decade.

In order to finance this prolonged deficit Gulf regimes have simulataneously adopted several approaches aiming at increasing revenues and cutting expenditures. The first one has been liquidating government deposits. According to the International Institute for Strategic Studies Saudi reserves were reduced from $120 billion in the early 1980s to $15 billion by mid 1990s[6]. Another method has been borrowing from the domestic market by issuing government bonds and treasury bills. Saudi internal loans, for example, soared from zero in 1987 to $84 billion by late 1994[7]. In the aftermath of the Gulf War the Saudi government, for the first time in decades, borrowed from international banks. Other Gulf states followed suit as table II shows,

Since oil prices have been falling in real terms for the last several years diversification, non-reliance on one commodity as the only source of income, has been perceived as an essential method to increase revenues. Recently, a variety of economic activities such as manufacture, agriculture, tourism, fishery, banking, and trade has attracted governments' attention and investment all over the region. Saudi Basic Industries Corporation (SABIC) is playing a growing role in terms of employment and contribution to the GDP. The role of U.A.E as a commercial center is flourishing particularly with the establishment of Jebel Ali free zone.

Privatization has been one of the most controversial approaches

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[4] The term was used by Lisa Anderson., "Liberalism, Islam, and the Arab State." Dissent, vol.41, no.4, Fall 1994, p.440.

[5] Middle East Economic Digest., "Oil and Gas," vol.39, no.14, April 7, 1995, p.24.

[6] International Institute for Strategic Studies., Strategic Survey 1994-1995. New York: Oxford University Press, June 1995, p.148.

[7] Mark Nicholson, "Profit Squeeze Tightens," Financial Times, December 15, 1994, p.35.



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to finance the deficit because it erodes the state's monopoly of economic leverages. In a sense, privatization strengthens civil society and leads to a new distribution of economic and political power. Since the early 1990s the six Gulf monarchies have taken different stands in regard to relaxing their control over the economic system. Both Bahrain and Kuwait have been vigorous selling government share-holdings in shipbuilding, banks, and telecommunications. Oman and Qatar have followed suit but in a slower rate. In May 1994, King Fahd of Saudi Arabia endorsed privatization. However, the government has adopted a cautious and gradual approach. United Arab Emirates has been the most reluctant due to the absence of a formal stock exchange market and the preference of its rulers to take a "wait and see" approach to see how it will work in other Gulf states.

Cutting public expenditure has been the hardest approach and the one all Gulf monarchies tried to avoid and delay as long as they could. Total budget expenditure by the six states was reduced to $71,100 million in 1994, compared with $81,300 million a year earlier. Since 1994 the governments in Bahrain, Oman, and Qatar have had plans to cut public expenditure. Public projects are still going ahead, but large scale infrastructure schemes are rare. In Kuwait, charges for public services and reducing subsidies on domestic utilities, petrol and telephone services are under consideration. The federal government budget in U.A.E has been frozen at its 1993 level through 1995. In addition, the price of electricity was doubled in November 1994 and early in 1995 new health care fees were announced. In 1994 Saudi government spending was cut by 19%. The 1995 budget foreshadows 6.2% additional cut in public spending, the lowest since 1988. It includes reduction in education expenditure, health and social development, municipal and water development, infrastructure, industry and electricity as well as subsidies and lending by state agencies.

To sum up, there is a growing consensus among the ruling elites in the Gulf monarchies that they can not afford funding the generous welfare state of the 1970s and 1980s. The prolonged deficit since the mid 1980s cannot be attributed solely to the impact of war. Rather, there has been a structural imbalance caused by heavy dependency on oil and a dominant role of the state in the economic system. However, it is important to point out that Gulf states are not poor, rather they are going through a process of transition from political



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economy of abundance to a one of relative scarcity. The changing economic and financial environment for the last decade has dictated some measures of fiscal discipline which has, in its turn, paved the way for a political discipline as the next section explains.

**Political Reform**

Since the early 1990s many intellectuals and religious figures addressed petitions to the rulers of the Gulf states. The uniformity of these demands as well as their coincidence confirm the proposition that political reform was introduced in response to the decline of the welfare state. These petitions called for equality before the law, accountability of all officials, purging corruption, consultation, exclusion of foreign cultural influences, stricter adherence to Islamic values, cut in oil production to increase prices, and opposition to close relations with the west and Peace with Israel.

It is important to emphasize that the majority of these oppositions aim at reforming their political systems from inside, not overthrowing them. In addition, the common denominator of these petitions is the opposition to the arbitrary form of government. However, there is not enough evidence to judge how democratic these opposition groups are.

In response to these growing demands for participation the six Gulf monarchies have adopted a carrot and stick approach. In December 1992, the government of Bahrain created a thirty-member appointed consultative council. This body consists of business and religious figures but has no legislative power. In 1994, the government clashed with a Shi'a opposition group led by Ali Salman, who has called for the establishment of an elected parliament. Considering its unique historical and international circumstances, the movement toward broader participatory institutions has gained more concessions from the government in Kuwait than in any other Gulf state. In 1992, elections were held and opposition candidates took more than thirty seats out of fifty and consequently were represented in the government. Since the elections, the opposition-dominated National Assembly has steadily increased its supervisory power over the government including investigating corruption committed by members



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of the ruling family[8].

In 1991 caucuses of prominent citizens in Oman nominated three citizens per province for a new consultative council[9]. The Sultan selected one nominee per province. The Council has the right to review legislation regarding cultural, social, and economic issues. However, it has no right to review foreign and defense policy issues or to interrogate ministers in these areas. There have never been elections in both Qatar and U.A.E. In the former, the forty-member Consultative Council appointed in 1972 still sits. In the latter, the Federal National Council consists of advisers appointed by the rulers of each emirate. The councils in the two countries have no legislative authority.

Since the early 1990s, Saudi Arabia has experienced a significant domestic political change. This unprecedented change reflects the government's attempt to contain the growing dissatisfaction by its people. In 1993 the King established 13 regional assemblies for each of the Saudi provinces. Members of the royal family preside over these forums. In the same year the Consultative Council was created to debate, review, and offer advice on domestic and foreign affairs. Moreover, its members retain their positions in the government. Considering this tight government control of the political system, an assertive opposition has been growing outside the official institutions. In 1993 the Committee for the Defense of Legitimate Rights (CDLR) was established to monitor human rights abuses in the Kingdom. The government declared CDLR illegal. Its founders lost their government jobs and were detained for different periods. Its spokesman Muhammad Masa'ri, a physics professor, fled to Britain in April 1994. In addition, two charismatic preachers, Salman Al Auda and Safar Al Hawali, led the Islamic opposition criticizing domestic corruption and foreign policy issues. In response, the government arrested them as well as many of their followers. In addition, the Saudi regime has introduced many administrative

[8] In 1994 the Parliament cleared the way for a criminal court to begin trying Sheik Ali Khalifa Al-Sabah, a former minister, who is accused of embezzling $100 million from the state-owned Kuwait Oil Tanker Company.

[9] In 1994 the Sultan expanded the membership of the new Council to eighty seats and including two women.



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measures to control the Islamic movement. These include the creation of a new Ministry of Islamic Affairs in 1993 to take the responsibility of the Kingdom's Islamic universities, the establishment in 1994 of Da'wa (religious propagation) Council to monitor mosques and sermons, and the formation of Supreme Council for Islamic Affairs to coordinate Saudi foreign policy in the Islamic world. Finally, in an attempt to control the flow of information, the government banned television satellite dishes in 1994.

A number of conclusions can be drawn from the foregoing review of political changes in the six Gulf monarchies.

First, rentier state: a proper way to understand economic and political changes in the Gulf monarchies is to apply rentier analysis. This approach suggests a strong correlation between the heavy dependence on external source of income (oil), and the distributive (in contrast to productive) nature of the state. In other words, considering the huge oil revenues in the 1970s and early 1980s, Gulf monarchies did not need to extract taxes from their populations, instead, the state was able to provide a "cradle-to-grave" welfare system and to buy political consent. The citizens, on the other hand, not having to pay taxes and enjoying a vast array of free or heavily subsidized products and social services, had little incentives to demand participation and accountability. The collapse of oil prices since the mid 1980s has made this political formula invalid. According to this line of reasoning both the popular dissension and the state's attempt to contain it are a mere reflection of the diminishing financial resources. The state does not have enough wealth to "de-politicize" its people. Rather, the two sides are in the process to reach a new social contract.

Second, liberalization in response to external threat: As the first conclusion suggests, political reform has been used to absorb domestic popular dissatisfaction, in addition, it has also been used as a safeguard against external threats. Since their establishment as independent states only Bahrain (1973-75) and Kuwait (1963-76, 1981-86, 1992-) had had elected national legislatives. The other four states (Oman, Qatar, Saudi Arabia, and UAE) have never held elections for such a forum. Examining the four cases of elected assemblies suggests that the Bahraini and Kuwaiti rulers had accepted popular representation only to protect their regimes. In Kuwait, the first elections were held early in the 1960s when President Qassem of



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Iraq was threatening to annex the newly-independent state. In response to threats of radical Islam inspired by the rise of Ayatollah Khomeini in Iran, the Kuwaiti regime felt the need for elections to secure public support. When Iraq invaded Kuwait in 1990, the Emir pledged to restore the constitution and to hold elections upon liberation. The Bahraini experience is very similar to the Kuwaiti one. When Britain decided to withdraw from the Gulf in the early 1970s, the Shah of Iran claimed that Bahrain belonged to his country considering that the archipelago had long been part of the Persian empire and the majority of its population were and still are Shia'a. A referendum was held in which the majority of the population favored independence. However, there was a promise by the royal family that elections would follow. They did fulfill their promise and elections were held in 1973, but a little later (1975) Bahraini royal family formed an alliance with Saudi Arabia and dissolved the elected assembly. Since then, elections were never held again.

Third, Civil society: Civil society consists of different institutions such as family, tribe, business association, labor unions, and others which lies between the state and the individual and protect the latter from the abuse of power by the former. A distinctive character of the political process in the six Gulf states is the absence of such independent organizations to mediate between the citizens and the political authority. Political parties are illegal in all of them[10]. The composition of their labor force (a vast number of foreign laborers) has removed indigenous labor issues from the political agenda. Professional syndicates, social and sport clubs are under strict government control. The only forum which has been functioning freely, relatively speaking, from the heavy hand of the authority is the mosque. However, lately Gulf regimes have felt the threats coming from these mosques and started expanding their control over them. In addition, an informal family-based social gathering known as "Diwaniyya" has been playing an important role in discussing public issues and developing political consensus. Considering their informality, these diwaniyyas have enjoyed a certain degree of autonomy and independence from the governments.

[10] Seven informal blocs, acting much like parties, were formed during the 1992 elections in Kuwait and have since been present in succeeding National Assembly sessions.



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The above analysis strongly suggests that reform, both economic and political, was introduced and has implemented more as a tactical maneuver to adjust to a changing environment and less as a genuine commitment to democratic values on the part of the ruling families. This raises an important question regarding the durability and extent of this reform or, in other words, the stability of Gulf regimes. Prophecy is a dangerous game and probably it is unsafe to draw one scenario, rather it is more appropriate to analyze the domestic, regional, and international forces which together would shape the future of the Gulf monarchies.

**Succession Crises**

The royal families dominate the political systems in all the six Gulf monarchies. In addition to the positions of head of state, crown prince, and prime minister, they control the most sensitive and powerful ministries. As of late 1995 family-members in five states held the defense and foreign affairs portfolios and in four they held the interior portfolio. Given the tremendous power these political elites enjoy, the following table reviews the succession in all the six Gulf monarchies since their establishment as independent sovereign states.

A number of conclusions can be drawn from the above table, first, two states (Bahrain and UAE) have had only one ruler since independence, the other four have experienced nine episodes of succession: four of them were by natural causes (death), the other five can be described, more or less, as palace coups. However, these "coups" did not produce any drastic change in the socio-economic andpolitical orientation of the state. Second, in all the six states the royal families have shown an impressive degree of stability. In addition to the absence of a serious challenge to their regimes since independence, these rulers have been able to survive resounding regional threats such as the Iranian Revolution, Iran-Iraq War, and the Gulf War. This durability of the six royal families proves the solidarity of their bases of legitimacy (oil wealth, Islam, and tribal traditions.) Third, most of the Gulf rulers are in their sixties and seventies which suggests that within the next few years there will be a transition of power to the next generation. With the absence of institutionalized procedures of succession it is not known how smooth the process can be. In addition, the skills of the sons to sustain the



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**Table III**
**Accessions to the Throne in the Gulf Monarchies**

| *Ruler* | *Reign* | *Comment* |
|---|---|---|
| **Bahrain: Independence date: August 15, 1971** | | |
| Isa Ibn Sulman Al-Khalifa | 1971- | |
| **Kuwait: Independence date: June 19, 1961** | | |
| Abdullah Al-Salim Al-Sabah | 1961-1965 | Died |
| Sabah Al-Salim Al-Sabah | 1965-1977 | Died |
| Jaber Al-Ahmad Al-Sabah | 1977- | |
| **Oman: Independence date: December 20, 1951** | | |
| Said Ibn Taimur | 1951-1970 | Deposed by his son |
| Qaboos Ibn Said | 1970- | |
| **Qatar: Independence date: September 1, 1971** | | |
| Ahmad Ibn Hamad Al-Thani | 1971-1972 | Deposed by his cousin |
| Khalifa Ibn Hamad Al-Thani | 1971-1995 | Deposed by his son |
| Hamad Ibn Khalifa Al-Thani | 1995- | |
| **Saudi Arabia: September 23, 1932 (declared a unified kingdom)** | | |
| Abd Al-Aziz Al-Saud | 1932-1953 | Died |
| Saud Ibn Abd Al-Aziz | 1953-1964 | Deposed by his brother |
| Faisal Ibn Abd Al-Aziz | 1964-1975 | Assassinated by his nephew |
| Khalid Ibn Abd Al-Aziz | 1975-1982 | Died |
| Fahd Ibn Abd Al-Aziz | 1982- | |
| **United Arab Emirates: December 2, 1971** | | |
| Zayed Ibn Sultan Al-Nahyyan | 1971- | |

Source: Europa Yearbook, (London: Europa Publications, 1970-94).



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balance within the royal families and to keep different clans satisfied are questionable.

To sum up, considering the strong basis of legitimacy these royal families enjoy and the longevity of their regimes, it seems that in the short to medium range they will be able to overcome different domestic challenges. The most likely scenario for change is a palace coup within the same family. This can be provoked, among other things, by an alteration in the dynamics of the regional balance.

**Regional Stability**

Developments in the Gulf region as a sub-system and the Middle East as a whole would play a significant role in shaping the future of the six monarchies. Over the last several years the regional system has created a less secure and more violent environment. Four regional threats to the stability of the Gulf regimes can be identified. First, Arab-Israeli conflict and the peace process. The six monarchies have supported the peace efforts since the end of the Gulf War. They partially lifted the economic boycott against Israel and pledged millions of dollars for the Palestine National Authority in Gaza and Jericho. In addition, the Israeli Prime Minister Yitzhak Rabin made a brief visit to Oman in December 1994, his first to a Gulf state. Moreover, Qatar negotiated a natural gas deal with Israel. Considering the strong Islamic and popular opposition to the peace process particularly in Saudi Arabia, set-backs can be of great embarrassment to the Gulf regimes.

Second, Islamic movements represent the main opposition in almost all countries in the Middle East. A great deal of alliance and re-alliance is taking place every day across the region. A victory for the Islamists in Algeria and/or in Egypt would feed the fundamentalist opposition in the Gulf monarchies. These regimes were able to survive the nationalist wave which swept the region in most of the 1950s and 1960s, but their ability to contain an Islamist wave is in doubt. In an attempt to counter the rise of Islamism and to coordinate efforts with other Arab regimes Saudi government banned independent charities run by Islamists that reportedly financed anti-government militants operating in Algeria, Egypt, Tunisia and Jordan. Moreover, the Gulf states adopted the anti-terrorist "Code of Conduct" at the Casablanca Islamic summit in December 1994.



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Third, many of the six Gulf monarchies have border problems and other disagreements with each other. These include the Bahraini-Qatari dispute over the Hawar Islands, the Kuwaiti-Saudi over the Garuh and Umm Al-Maradim, and the Saudi-Qatari over their common boundaries which was escalated to a minor military confrontation in 1992. In addition, the political reform and elections in Kuwait are not comfortably received in other Gulf monarchies worrying about the spillover or what Huntington calls "demonstration effects[11]." Over the last few decades Gulf regimes have demonstrated their ability to work together when faced with external challenge such as the Iranian Revolution, the Iran-Iraq War, and the Gulf War. But these differences tend to resurface when these external threats recede.

Finally, and most important, the threats from the two strong neighbors Iraq and Iran. There is a tremendous imbalance in the distribution of resources and military power between the six Gulf monarchies on one side and both Iraq and Iran on the other side as the following table shows,

The above table shows the disparity between the two sides in terms of economic prosperity measured by PPP and military power measured by the size of their armed forces. It is also important to point out that both the Iranian and Iraqi armies are better trained and battle-tested but the six monarchies have more updated and better military equipment. The figures prove that both Iran and Iraq have the military and demographic capabilities and the economic incentives to pose a challenge to each other as well as to the other six neighbors regardless of the ideological orientation in Tehran and in order to fill this power vacuum the six Gulf monarchies have pursued a twofold strategy aiming at increasing their military power and cementing their alliance with Western countries, particularly the United States.

In the next several years this strategy would probably deter Iran and Iraq from launching a large-scale military aggression against the other Gulf states. However, in the long term, a security and political system in which both Iran and Iraq are incorporated needs to be established

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[11] Samuel P. Huntington., The Third Wave: Democratization in the Late Twentieth Century. Norman, Oklahoma: The University of Oklahoma Press, 1991.



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**Table IV**

**Imbalance of Economic and Military Powers in the Gulf, 1994**

| *Country* | *1* | *2* | *3* |
|---|---|---|---|
| Bahrain | 00,546,000 | 11,536 | 008,100 |
| Kuwait | 01,272,000 | 13,126 | 016,600 |
| Oman | 01,922,000 | 09,320 | 042,900 |
| Qatar | 00,513,000 | 14,000 | 010,100 |
| Saudi Arabia | 17,999,000 | 10,850 | 104,000 |
| UAE | 01,686,000 | 17,000 | 061,500 |
| Iran | 61,168,000 | 04,670 | 513,000 |
| Iraq | 15,890,000 | 03,500 | 382,000 |

1= Population in thousands.
2= Purchasing Power Parities (PPP) adjust GDP to account for real buying power.
3 = Total armed forces in thousands.

Sources: Column 1 and 2 James Finn (Ed,) Freedom in the World: The Annual Survey of Political Rights and Civil Liberties 1994-1995. New York: Freedom House, 1995. pp. 123, 302, 306, 345, 443, 472, 495, 581. Column 3 International Institute for Strategic Studies., The Military Balance 1994-1995. London: Brassey's, 1994. pp. 124, 128, 129, 134, 135, 136, 137, 140. Baghdad.



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in order to secure the stability of the Gulf as well as the interests of the international system.

**The International System**

The stability of the Gulf presently hinges on the informal military alliance between the six Gulf monarchies and the West. For many years Western countries have committed themselves to the security of the Gulf for amongst other concerns a fundamental reason, oil. Table V sheds light on the significance of the Gulf for Western countries.

The above table shows the increasing share of the Gulf in world oil supply as well as the growing dependence of western countries on the imported oil from the Gulf. In addition, given the high constant level of consumption by members of the Organization for Economic Cooperation and Development (OECD) the stability and security of the Gulf have been of great interest to the West for many years and will continue to be.

Western countries have played, and will continue to play, an important role in the six Gulf states, protecting from regional threats. This has been demonstrated in western efforts to confront threats from both Iran and Iraq; to mediate any conflict between the six monarchies; to try to contain any dispute within the royal families; and to support a settlement for the Arab-Israeli conflict.

The West has succeeded in achieving most of these goals. However, an important dilemma confronting the West is where to stand in regard to the growing popular demands for political participation and the resistance by the Gulf regimes. It is the traditional problem of choosing between national interests and values, how to reconcile western support for democracy and human rights with its close relationships and defense of autocratic regimes. It is believed that "regimes that rest on institutionalized procedures for eliciting the consent of the governed are the best for long-term stability[12]." However, the process of democratization is very destabilizing. Moreover, opposition forces in the Gulf are less likely than the current regimes to accommodate western interests such as

[12] Gregory Gause., Oil Monarchies. New York: Council On Foreign Relations Press, 1994. p.183.



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**Table V**

**The Significance of Oil Supplies from the Gulf, 1984-1994**

| *Year* | *1* | *2* | *3* |
|---|---|---|---|
| 1984 | 19.1 | 60.6 | 38.0 |
| 1985 | 17.4 | 60.1 | 35.1 |
| 1986 | 20.1 | 60.2 | 40.9 |
| 1987 | 20.6 | 59.9 | 39.5 |
| 1988 | 22.1 | 60.1 | 42.4 |
| 1989 | 23.8 | 59.7 | 45.4 |
| 1990 | 24.3 | 59.1 | 47.2 |
| 1991 | 23.5 | 59.3 | 45.3 |
| 1992 | 25.5 | 59.9 | 45.4 |
| 1993 | 26.8 | 60.6 | 47.1 |
| 1994 | 26.7 | 60.9 | NA |

1= oil supply from the Gulf as a percentage of world oil supply.
2= OECD consumption as a percentage of world consumption.
3= OECD oil imports from the Gulf as a percentage of its total oil imports.

Sources: Columns 1 and 3 Energy Information Administration., International Petroleum Statistics. Washington, D.C.: US Government Printing Office, February 1995. pp.9, 46, 48. Column 2 British Petroleum., BP Statistical Review of World Energy. London: The British Petroleum Company, June 1995. p.8.



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peace with Israel and low oil prices.

The close and intensive relationship between western governments and the royal families in the Gulf suggests that the West has chosen to support the status quo. Considering the current fragmentation and weakness of the opposition in all the Gulf monarchies this policy may protect Western interests over the next several years. However, the attitudes and interests of the larger society should not be overlooked when studying the long term stability in the Gulf.

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# The Impact of Multiculturalism on Liberal Education in America

Thomas K. Lindsay
*University of Northern Iowa*

## Declining Education and Inflaming Democratic Discourse

This essay addresses two problems that are intimately related. The first problem has become public knowledge: the decline in educational performance in the U.S.A. On this point, the results of one recent survey suffice. American high school seniors were asked to identify the half-century during which the American Civil War took place. A majority failed to answer correctly – and this was a multiple-choice question. The same study revealed that a majority of American high school seniors, when presented with statements taken from either the United States Constitution or Karl Marx's *Communist Manifesto*, could not identify which of the two texts was the source. It would seem that the two documents that, more than anything else, have shaped this century are virtually indistinguishable to most of today's American high school graduates.

The second problem is the decline in the civility with which public discourse is conducted. Not only is it getting more and more difficult for people to talk to each other, but even less do people listen, preferring a scorched-earth policy over discussion and compromise. From the universities, to the National Endowment for the Arts, to even the Boy Scouts, the culture clash between "traditional values" and "cultural diversity" is stretching democratic sensibilities nearly to the breaking point. On the Right, fear and anger are escalating in response to the perceived moral dissolution. On the Left, "bourgeois" notions of economic and political liberty are denounced as sham rationalizations in the service of class inequality. And from the most recent entrant into the fray, multiculturalism, we learn that mere toleration of diversity, the classical liberal solution, will no longer do: not toleration but nothing less than "celebration" must be the new moral imperative.

But if multiculturalists are unabashedly aggressive in their assaults on Western democracy, no less remarkable is the blanket passiveness with which their claims are met in American institutions



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of higher learning. The majority of my colleagues in the university, who believe in and practice mainstream liberalism, somehow find themselves intellectually and morally bound to support the multicultural agenda that is at this moment establishing ever more beachheads on the campuses. Or, if they do not support the new orthodoxy, they believe that their liberalism compels at least their silent acquiescence.

**Is Opposition to Multiculturalism Bigotry?**

At first glance, this is easy to understand. Among liberal Americans, who can be unsympathetic to multiculturalism's stated quest to give proper consideration to cultures other than America's own, and this as part of a larger project that aims both to broaden their vision and to abolish bigotry? Did not America's classical liberal Founders envision a society that practiced and cherished toleration? Given this, how could they object to the extension of this project to the universities? After all, liberal education at its deepest is the search for a common, basic human nature, unaffected by culture. In this search, liberal education can be the partisan of no particular culture, even of America's. Instead, it investigates and must investigate foreign ideas as well as cultures in its attempt to discover what it regards as the best, the most fully rational way of life.

As the above observations suggest, multiculturalism's quest to produce a people that "celebrates diversity" appears at first to be only a logical, if more committed, extension of the classical liberal project. And were this the case, one could simply identify multiculturalism with liberal education or, more precisely, one could aver that liberal education fosters and requires what I shall call "true multiculturalism" – true openness to the teachings of other cultures. But the harmony between liberal education and the current version of multiculturalism is only apparent. The project being pushed under the name of multiculturalism today bears little resemblance to what I have called true multiculturalism. Rather, the multiculturalism of today is more precisely described as "relativist" – or "radical multiculturalism." Between radical multiculturalism and liberal education lie differences so deep that the success of this version of multiculturalism cannot but spell the death not only of liberal education but also liberal democracy. This becomes apparent on examining multiculturalism's critique of the older, that is, the liberal, view of toleration.



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### The Attack on the Liberal Reconciliation of the Individual and the Community

Classical liberal toleration recognizes and aims to relieve the natural tension between, on the one hand, extraordinary individuals (who can also be quite peculiar, e.g., Socrates, Van Gogh, Howard Hughes) and, on the other hand, the moral-political community. To effect this reconciliation, that is, to do justice to both individual liberty and social cohesion, liberalism "tolerates" such individuals, while asking, in the name of social harmony, that they keep to themselves. In so doing, liberalism seeks to ensure the freedom required for "fringe" views and lives, while at the same time recognizing that a certain "closedness" is an inescapable requirement of moral and political health. While citizens in a liberal regime would not be the subjects of Socrates (and some might decline even to be his students), neither would liberal citizens be Socrates' executioners.

But while liberal toleration has been successful over the last two centuries in making liberty acceptable to partisans of democratic equality as well as republican virtue, it has yet to make its peace with that species of post-modernism that I have labelled "relativist-multiculturalism" – and with good reason, for at the bottom of the current version of multiculturalism lies the conviction that all values are equal (because all are equally unknowable by reason); therefore "self-creation," rather than rational discovery (classical liberalism's focus), has become the post-modern standard of human dignity. Given this jettisoning of the idea that there are authoritative standards of virtue and vice, equality in of rights (the classical liberal project) is no longer sufficient, and must be replaced by equality in people's "lifestyles."

Hence, indiscriminate toleration, even "celebration," has supplanted the older, republican concern with civic virtue. But whereas older versions of republicanism sought to subordinate "each to the all" (sought to subordinate each individual to the community's view of the common good), radical multiculturalism looks to subordinate "all to the each" – that is, to each and every, necessarily idiosyncratic, version of self-creation. Stated simply: morality grounded in nature's amorality; equality grounded in reason's impotence at "prioritizing values"; and liberty grounded in the inability to distinguish liberty from license – these are the leading



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characters in the multiculturalist drama.

Against my diagnosis, many of my colleagues offer a very common-sensical, in fact, a very liberal, response. They argue that the multicultural agenda, while it aims radically to transform society, will in time come itself to be transformed, that is, to be moderated, by society's moral demands. In this account, multiculturalism's ideological excesses will inevitably produce a backlash from which all but its most ardent proponents will flee to the safer havens of moderation. Accordingly, the celebration crowd will come to recognize that its demands for more than mere tolerance endanger social harmony and, with it, the grounds of its own liberty. Faced with the self-undoing recklessness of their more excessive demands, they will act soberly to retract them. Because Americans live in a mass democracy, because here public opinion finally reigns supreme, multiculturalism, so I am told, will be changed as much as the society it seeks to change. The net result will be a society that is more tolerant and an intellectual class that is more restrained. As a Marxist professor recently argued to me, "Multiculturalism, like everything else that pretends to significance in America, will come in time to be co-opted."

I am less soothed by this forecast than are some of my colleagues, because I cannot believe it. Certainly there is no denying that such appeals to prudence, to moderation, and to self-preservation have been successful for the last 200 years, that is, have been successful during classical liberalism's reign. But will they prove persuasive with liberalism's latest critics? In trying to answer this question, we need first to examine more closely what accounted for liberalism's principled victories over its past opponents.

**The Liberal Case for a Common Human Nature**

The arguments of Hobbes, Locke, Montesquieu, and the Founding Fathers succeeded in making America the first regime to ground its fundamental moral and political principles on the authority of reason alone. As Jefferson makes clear in the American Declaration of Independence, that government alone is legitimate that discerns and embraces the "self-evident truths" of human nature. Primary among these truths are natural equality, inalienable rights, and hence, the merit to be governed only by consent. These truths and their political implications, as articulated in the Declaration, form



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what has been called the "American creed" or the American theory of justice.

But to whom are these truths self-evident? They are self-evident, the Declaration implies, only to those who use their powers of reason to comprehend what it means to be a human being, what it is that separates us from the animals, and what it is, therefore, that all human beings deserve. From this rational self-examination, liberalism's founders gleaned that all human beings share at bottom the passion for and subsequent right to life and the liberty life requires. The social contract relies on the capacity of all to employ their reason toward these fundamental ends. On the basis of this view of the universality of reason's service in the moral and political realms, America's Founders thought themselves justified in announcing the universal proposition, "all men are created equal."

Hence, for the American Founders, reason both unites and guides. In point of fact, it does not go too far to say that the American principles of government stand or fall on the basis of the final power of human reason to serve as both the core of America's identity and as its beacon.

### The Fall from Life, Liberty, and the Pursuit of Happiness to the Lawless Liberty of the Soulless Self

But for radical multiculturalism, reason has fallen from its throne. In the present epoch, both Marx on the Left and Nietzsche on the Right agree on reason's merely subordinate status. With the subsequent rejection of the notion that rationally discerned and grounded rights are the fundamental facts of humanity, that which is now argued to be fundamental – whether it be race, or class, or gender, or power, or creativity, or sexual orientation – no longer unites Americans, as did classical liberalism's world view, but, instead, forever separates them. All of these formulas find fundamental differences to outweigh the sameness to which liberalism looks in positing a universal "human nature" on which liberalism's rights-doctrine relies. Stated simply, humanity understood as unprincipled creativity leaves no truly *common* appeal to make in politics nor any common education to provide in the nation's schools.

For this reason multicultural education balkanizes the study of human nature into "women's studies," "black studies," "gay and lesbian studies," etc. In this light, I find the best short definition of today's



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multiculturalism to be this: radical multiculturalism is a quota system for books. Books and their ideas deserve such "proportional representation" in the curriculum only if all ideas are equal. And all ideas can be equal only if reason is rendered powerless.

I want to stress this point: when reason – which is at the core of the liberal definition of human nature – was repudiated, so was any possibility that we could discover objective natural standards on the basis of which compromise might be reached in the name of respecting equal rights. Today, mere equality in rights is not only insufficient, it is insulting, it is oppressive, in the eyes of those for whom only equal dignity can be justice.

**Multiculturalism versus Social Harmony**

This is why I am less than confident that multiculturalism will come to moderate itself in the face of the demands of social harmony. After all, the downfall of reason and the resulting balkanization of what is now only nominally (and derisively) referred to as "human nature" can justify – for Nietzsche, does justify – the merciless extinction of multitudes in the name of some self-creative act. Absent any objective moral standards, the new individualist cannot be censured for pursuing violence if he should deem his self-creation requires it. In fact, given the post-modernist contempt for liberal toleration – to cite one massive example, the post-modernist Richard Rorty comes close to praising what he calls the "private poem" in the "sadist['s]" "extreme cruelty" – should we expect anything less than violence? Years ago Supreme Court Justice Jackson argued that principles have a way of working themselves out to the "limits of their logic." Therefore, in the face of the post-modernist world view, I cannot help but conclude that classical liberal, prudential arguments for political moderation come much too late.

What is more, the liberal conviction of the goodness of political moderation itself depends on the prior conviction that political life is limited in its ability to provide all goods to all people. For the genuine liberal, the limitations of politics follow logically from the limitations of human nature. As James Madison states the point in *Federalist* 51, "if men were angels, no government would be necessary." This means that any recognition of the limits of politics requires first looking to a standard that transcends politics, that is superior to politics. But today's multiculturalism, grounded in



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relativism, denies trans-political standards. At the same time, it argues that the "self" – in the name of which it would transform society – is itself radically derivative of society. As Rorty puts it, "Socialization goes all the way down, and who gets to do the socializing is often a matter of who manages to kill whom first."

Hence, from this post-modern marriage of cultural relativism and cultural determinism, the "self" finds itself both radically above and radically below culture: culture stands as both absolute and groundless. While this may appear as a contradictory proposition, it is so only from the standpoint of (what multiculturalists have of late come to call "logocentric," or "Eurocentric," or "phallocentric") reason, which is now viewed as only one more of the groundless orthodoxies of (to use Rorty's description) the "rich North Atlantic" democracies.

So, again, I cannot help but be less confident than are some of my colleagues in the ultimate effectiveness of their very prudent and very temperate appeals in the face of the intemperance of this new "anti-Science" Science. Arguments for social harmony will be denounced on the grounds that such appeals are anchored in a notion of the limits of "human nature," a notion which is said to be a product of bourgeois prejudice (on this point, and again, both Marx and Nietzsche agree, although for clearly different reasons). In fact, any arguments for moderation based on a view of the limits of political justice must be denounced: "creativity" is alleged to know no limits.

The question then becomes, "How did America come to this point?" After bemoaning the menace of relativist-multiculturalism, those who insist on continuing to defend liberalism and liberal education are also duty-bound to ask what responsibility liberalism itself bears for America's decline. A question: Would it be remarkable if the principles of classical liberalism's "naked public square" have managed, in America's two hundred years as a nation, to "trickle down" to the private sphere? We may have to concede, if grudgingly and with important qualifications, that the moral cohesion and community support offered by the private sphere during America's earlier period were in part the product of a collective hangover from institutions and practices – religion, tradition, and the extended family – that liberalism's own principles helped to "demystify." Their having been already weakened by liberalism, is it truly remarkable that these havens of the private have become easy



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prey for those multiculturalists who now view them only as enemies of "diversity"?

If we grant that liberalism at least opened America to its current balkanization, then we need also to ask ourselves whether radical multiculturalism represents, in key respects, the attempt to reestablish community on the ashes left by liberalism and relativism. That is to say, liberalism did away with the trans-political authority of religion, tradition, and the extended family. Relativism, in turn, by denying reason its former power, closed it off from access to trans-political natural standards. Therefore, all that is left as a support for community is the solitary, unsupported "self." The question then becomes how to construct community out of a diversity of uncommon "selves." The answer: only by celebrating diversity, which means that only the community that is not a community can satisfy the self without a soul (fixed nature).

In this light, perhaps we should not be surprised that the "anti-community" community, in order to be set in motion, must uniformly impose diversity-celebration on those who would dare to claim knowledge of and guidance from any standards superior to standard-less self-creation. Stated simply, radical multiculturalism aims to remedy what it perceives as classical liberalism's failure at supporting community, but it does so on the basis of the success of relativism; therefore, diversity-as-monolith (= political correctness) imposes the communal value of value non-imposition (= diversity-celebration) – and all this in the name of the lawless liberty of the soulless self.

**The Atomizing Emphasis on "Rights"**

Recently a number of thinkers have noticed and become concerned over liberalism's atomizing emphasis on rights. Perhaps the latest is Mary Ann Glendon's thoughtful book, *Rights Talk.* Glendon urges as a counterbalance to this problem a return to vigorous moral discourse in peoples' private lives. Her's is a serious project at which we need to look hard. At the same time, given current political and cultural tendencies, we need also to ask where and to what extent there will remain an autonomous sphere of the private in which to foster and nourish private morality. Some age-old answers to this question are, first, "private associations" and second, and more important, the family. But consider the present and likely future status of both under the post-modernist political agenda. For



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the last three years, one such "private association," the Boy Scouts, has come under legal attack for discriminating against prospective Scout leaders on the basis of sexual orientation. Is this an unrepresentative fluke? One might think so were it not for the fact that the leader of the initial attack on the Scouts, Roberta Atchenberg, was subsequently appointed to be assistant secretary for fair housing at HUD.

Consider also the growth of the movement seeking to grant to children the right to sue their parents – for which a Florida judge in 1992 lent the precedent. In the name of the post-modern vision of "liberty," the realm of the private must suffer a shrinking. Therefore, pointing to families and private associations as safe havens for nourishing morality, while a very laudable goal, was a much more viable option in Tocqueville's day (it was he who first proposed this as a remedy to democratic conformism). Because today is not Tocqueville's day, I wonder whether the hostility with which any autonomy-promoting agenda will be viewed by the totalitarian-tending project of post-modernist "emancipation" if fully appreciated today. And in this light, the diversity-enforcing speech restrictions so in vogue at a growing number of American universities appear to be but the first step in a project that requires for its fulfillment its extension to society as a whole.

**Conclusion: The Future of a Delusion**

It is not simply that radical multiculturalism is bad education, trendy education, education lacking any real substance. All these things it is; but as bad as this is, today's multiculturalism – this new and deluded education in separatism – threatens America with consequences even more far-reaching and pernicious than the "dumbing down" of its children. Because, while radical multiculturalism might not teach today's students even the simplest facts about American history, what it does teach them threatens to bring on them only more separatism, hostility, and violence, leading in time, perhaps, to a new civil war.

Clearly, the picture for America as a multi-cultural society, as presented in this argument, is somewhat bleak. Doubtless, the possibility of a truly liberal way of life requires that people discover once again that there is actually something worth looking up to, that is, it requires that they refute Rorty's claim that "there is nothing to



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people except what has been socialized into them." What is required is a relearning of the idea that natural standards can be discovered through reason, rather than merely idiosyncratically created through "private poems." Without the possibility of intellectual freedom or self-understanding (rather than mere "self-creation"), those who today would purge both the American curriculum and its politics of its largely "Eurocentric" focus are likely to carry the day.

How likely is such a renaissance to occur? A strong case can be made for the expectation that many, both in the academy and out, will continue to believe that radical multiculturalism is only liberalism taken seriously. Back in the '20s and '30s the American left had a favorite line. They told us that "communism is only twentieth-century Americanism," and some well-intentioned Americans believed it. The parallel between the older Communism = Americanism formula and the present multiculturalism = liberalism formula is frighteningly perfect.



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# Union Myopia and the Taxation of Capital

Dwight R. Lee
*Ramsey Professor of Economics, University of Georgia*
Robert L. Sexton
*Professor of Economics, Pepperdine University*
Philip E. Graves
*Professor of Economics, University of Colorado*

As with managers, politicians, or any other groups of decision makers, workers will appropriately weigh the future when it is in their private advantage to do so. Private ownership plays an important role in providing the proper set of incentives. Workers own the future income streams their human capital allows them to generate. As a result, they willingly sacrifice current income in order to invest in their human capital by going to college, taking training courses, and working at low-paying jobs which provide opportunities for valuable experience and future advancement. Empirical work on the rate of return from educational expenditures indicates that future returns are heavily weighted when people are investing in their own human capital.[1]

As far as individual workers are concerned, however, sacrificing current income in the form, say, of a lower current salary in order to invest in the future productivity of the firm for which they work is an entirely different matter. In the first place, each worker would incur personally the entire cost of his or her lower salary while realizing that the future benefits from increased productivity would be spread over everyone with a financial stake in the firm. Each worker would have an obvious motivation for resisting a reduction in his or her salary in order to make such an investment. Secondly, in their roles as workers, individuals will perceive no benefit from improved firm productivity beyond the point in time when they sever their employ-

1. See George Psacharopoulos, "Returns to Education: A Further International Update and Implications," *Journal of Human Resources*, 20, no. 4 (Fall 1985): 583-604, for a discussion of many of the empirical studies on the return to education. Also see Kevin Murphy and Finis Welch, "Wage Premiums for College Graduates: Recent Growth and Possible Explanations" *Educational Researcher*, May 1989, pp.17-26.



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ment connection with the firm. Given the mobility of the work force, and the significant percentage of the work force which at any point in time is within a few years of retirement, it is clear that socially productive capital investments with extended pay-back periods will offer little attraction to a large number of workers.[2]

It can be argued that organizing workers in a union is a means whereby these problems can be mitigated. Unions supposedly make it possible for workers to acquire collective benefits that they would not be able to obtain if required to negotiate with their employers as individuals.[3] For example, when wages are determined collectively, each worker will be more willing to sacrifice current wages for future increases in productivity and wages, since the sacrifice of one worker will be accompanied by the sacrifice of all others. Therefore, it can be argued that workers, voicing their preferences through a union organization, will discount future returns less than they would in a nonunion setting. Also, unions have an organizational existence that extends beyond the working lifetime of their individual members. This, it can be argued, provides an additional reason for believing that wage and salary demands transmitted through unions will reflect a longer-term perspective than would otherwise be the case.

There are two responses to this line of argument which need to be considered. First, under traditional arguments, the time horizon of business decisions depends very little on the time perspective of workers with respect to the trade-off between current wages and long-term business investment. In all aspects of economic activity, specialization is important. Those who are residual claimants to the present value of the firm's profit stream, or those who are agents for

2. Workers' ownership of stock in the company they work for will lengthen their time horizon with respect to the firm's productivity. But as a practical matter, for most employees their return from salary will dominate what they can expect to receive from dividends and capital gains, and therefore their time perspectives, as they relate to the firm's capital decisions, will not be appreciably affected by stock ownership.

3. Unions have recently been defended as efficiency-increasing organizations with the argument that many features of the work place are accurately characterized as public goods, and that unions allow workers collectively, and therefore effectively, to communicate their demand for these public goods. See Richard B. Freeman and James L. Medoff, *What Do Unions Do?* New York, Basic Books, 1984. For a critical evaluation, of this perspective on unions, see Morgan O. Reynolds, *Power and Privilege: Labor Unions in America* (New York: Universe Books, 1984), pp. 71-72, 77-80.



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these claimants, are in the best position to specialize effectively in making decisions which affect the firms' long-run wealth and productivity. These decisions are guided, of course, by market information on relevant interest rates, the revenue potential of particular product choices, and the value of different input mixes in alternative employments.

Workers specialize best in this process by staying informed on their opportunity cost, increasing this cost within limits determined by their individual abilities and preferences, and refusing employment with those firms which refuse to cover this cost. Employees have a strong motivation to do all of these things. Just as few workers have to extend themselves beyond their narrow specialties and worry about agricultural decisions as a means of putting food on the table, neither do they have to concern themselves with the long-run consequences of business investment decisions in order to ensure that the capital base, upon which their real wages depend, continues to grow.

The appropriate responses to the argument that unions last beyond the time horizon of workers is that this is largely irrelevant. It is not the longevity of an organization that is important to the discounting of the future, but rather the incentives built into the organization's structure. After all, corporations commonly outlive their shareholders and this provides no basis for insisting that corporate arrangements are ideal at motivating decision-makers to apply the appropriate discount to the future. And the same is true for union arrangements. Indeed, the incentives built into union organizations are less conducive to weighing the future adequately. Any move in the direction of substituting union control for traditional control over a firm's decisions will only shorten the time horizons for business decision making.

The comparison to which our discussion has led us is between the organizational incentives of unions and those of corporations and the relative effectiveness of these incentives at motivating future-oriented decisions.[4] The important distinction between unions and corporations in this regard centers around arrangements involving property

4. The problem of motivating agents to remain responsive to the long-run concerns of their principals is, in the case of business organizations, at its most troublesome in corporations. Therefore, this comparison is, if anything, biased against viewing business organizations as being far-sighted relative to labor unions.



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rights. In the previous section, we examined the importance of transferable property rights, in the form of stock, as a means of reflecting the future consequences of corporate decisions and in providing both the means and the motivation to take those consequences into consideration. The myopia of unions relative to corporations is explained by the fact that unions do not come with comparable property rights, and therefore the long-run wealth effects of current decisions are not clearly registered in a way that feeds back into union decisions. There are several implications of this fact which are pertinent to our discussion.

Without transferable property rights reflecting the present value of employment opportunities in a firm or industry, the control of union members over the management of the union is quite limited. It is true that union members may have the right to vote on some levels of their leadership and on some of the recommendations made by that leadership. To this extent, the control of union members over union management is the same as the control of shareholders over corporate management. Well-informed and politically active voters can collectively keep management from deviating too far from their interests in both cases. The problem, of course, is that each voter, as a voter, has little motivation to be either informed or active, since his or her individual vote is unlikely to impact on the decision being made.

It is here that we can recall a major advantage of stock ownership that gives shareholders more control over their agents than union members will have over theirs. The shareholder has an additional margin on which to exercise choice both conveniently and decisively, and that margin comes from the ability to buy and sell corporate stock. The member of a union is in a much inferior situation in this regard. The union member would have to be prepared to change employers, and possibly occupations, in order to protect himself against the negative effects of poor management decisions as effectively as the shareholder can by simply selling his stock.

This means that union leaders will have more latitude within which to maximize their personal advantages and promote their own agendas then will corporate managers. The preferences of the union membership will not serve to constrain the decisions of those in union hierarchies as effectively as is the case of shareholder preferences vis-a-vis the managers of corporations.



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Also, little control can be exerted over union leaders through the sort of market for managers which does serve as a partial control mechanism in the case of corporations. Union managers typically work up from within a given union organization, with it seldom the case that a union leader will be brought in from the outside. With less opportunity for union leaders to profit financially from a reputation for promoting the interests of their membership, the connection between the self-interest of union management and the welfare of union members is further weakened. Thus, those in a position of power in the union hierarchy have a further degree of freedom to ignore membership concerns in favor of promoting their own interests.

One can expect then that, with respect to many issues, union decisions will not be representative of the interests of the rank-and-file member. This is particularly evident when the positions which unions take on political issues are contrasted with the political preferences of their members. Researchers have found, for example, that in a majority of questions posed to union members in national opinion polls, their positions differed (sometimes diametrically) from the positions for which their union leaders were lobbying in Congress.[5] Union management is able to continue indefinitely with political activities that are increasingly at variance with the views of their membership.

However, even if union leaders were perfectly responsive to the concerns of their worker members, they may still be relatively insensitive to the future consequences of current wage and salary decisions. Workers, not owning transferable "employment stock" that reflects the long-run value of their jobs, have little motivation to take the long view when balancing current wage demands against the long-run gains from maintaining and expanding a productive capital base. But arranging for the ownership of such "employment stock" would require that workers quite literally own their jobs, with the right to sell them to whomever they please. Such an arrangement would effectively remove all control over employment decisions from those who have supplied capital to the industry and would therefore greatly

5. See Dan Heldman and Deborah Knight, *Unions and Lobbying: The Representation Function* (Washington, D.C.: Foundation for the Advancement of the Public Trust, 1980).



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increase the cost of raising large amounts of capital.

There is little reason to expand on the unfeasibility of such an employee job ownership plan. The point is that, under reasonable property rights arrangements, workers will be less sensitive to the long-run employment effects of current salary, wage, and investment decisions than will corporate managers whose current compensation is directly tied to the price of stocks. If there is an issue upon which workers do focus, and which comes closest to being used as a monitor of the effectiveness of union leadership, it is the issue of current compensation. The quickest way for a union leader to incur the disapproval of the membership, and put his leadership position at risk, is by demonstrating an inability to extract current wage and benefits increases from employers.

**Government Policy and Union Power**

Union myopia with respect to business investment and capital formation would pose no threat to economic productivity and growth in the traditional U.S. setting where government is confined to a rather limited role in economic affairs. The economic role of government as envisioned by the Founding Fathers, though limited, was crucially important. Government was to create an economic environment of stability and confidence in which the rules of the game rewarded productive activity, where people knew what those rules were and had confidence that they would not be constantly assaulted by political whimsy. The primary economic responsibility of the government in this regard involved protecting private property rights against both domestic and foreign violations, and enforcing voluntary contracts. In other words, the task of government was to serve as a referee, making sure the game was being played in accordance with constitutionally agreed upon rules. It was emphatically not to be the government's role to become an active participant in the economic game in order to determine outcomes favoring some participants at the expense of others.

Although the ideal of the minimal state has never been fully realized in this country, or in any other, there can be no doubt that for more than 150 years of U.S. history decisions on the allocation of business income between wages and capital investment were left almost entirely to the discretion of capital owners and/or their corporate agents. It is equally true that the exercise of this discretion,



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subject as it largely was to the constraints imposed by respect for private property, voluntary exchange, and open competition, resulted in a level of economic progress which served the long-run interests of workers as well as of capital owners. To the superficial observer, it may have appeared that the rule of property favored the interests of capital over those of the worker. The falsity of this view is apparent to anyone who examines, even casually, the growth of wealth through U.S. history and how this wealth has been distributed between capital and labor.

Nonetheless, the view that the rules of property and free exchange put workers at a disadvantage relative to capital owners has persisted, and over the last half of this century has been increasingly influential politically.[6] The result has been an obvious shift in the role of government away from that of the impartial enforcer of neutral rules to that of an active participant in the game, promoting outcomes favorable to the interests of workers.[7] Of course, the tilting of the playing field in favor of labor unions is not acknowledged as such. The impression given, as expressed by economists Heldman, Bennett, and Johnson, is that laws regulating labor relations provide "little more than a general framework within which labor exchanges take place largely in response to traditional market pressures."[8] These authors go on to show that this impression is completely false.

One of the more blatant examples of the government overriding market forces in the interest of particular workers is given by minimum wage legislation. Politically determined minimum wages, along with maximum hours restrictions, as provided for by the Fair Labor Standards Act (FLSA) of 1938, obviously deny both workers

6. Seldom is the notion of the disadvantage of labor challenged. It is simply accepted as a self-evident truth by most, including economists who are normally proud of their professionally honed skepticism. Economist William H. Hutt has, however, carefully examined the implications of the disadvantaged worker assertion and has called into serious question its validity. See W.H. Hutt, *The Theory of Collective Bargaining* (London: King, 1930). For a concise discussion of Hutt's insights in this regard, see Morgan O. Reynolds, *op. cit.* (n. 12 above): pp. 26-27.

7. More accurately, to the interests of the minority of workers who are members of labor unions.

8. See Dan C. Heldmann, James T. Bennett, and Manuel H. Johnson, *Deregulating Labor Relations* (Dallas: The Fisher Institute, 1981), p. 3.



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and employers opportunities to enter into mutually advantageous exchanges. Over 70 percent of the nonagricultural work force is currently covered by either federal or state wage and hour standards. And this surely understates the extent of government control, since it does not include those who, while not covered by FLSA-type legislation, are restricted by the Davis-Bacon, Walsh-Healy, or O'Hara-McNamara Acts.[9] It is not the purpose of this paper to elaborate on the unfortunate effects on nonunion and minority workers stemming from these restrictions of the labor market. It suffices here to point out that the above acts represent direct government action which shifts control over employment decisions away from capital owners and toward union leaders by denying market opportunities to nonunion workers.

With enactment of the National Labor Relations Act (Wagner Act) in 1935, the government created another instrument for granting unions power to distort market decisions in favor of organized workers. Although the impact of the Wagner Act was moderated to some extent in 1947 with passage of the Taft-Hartley Act, the history of the National Labor Relations Board (NLRB), established by the Wagner Act, shows a consistent pattern of decisions favoring union power.

If, during a certification election to determine if a union is to be the *exclusive representative* of the employees, the NLRB decides that the employer has committed an "unfair labor practice," the Board can order the employer to grant recognition to the union. This has been done even when the union clearly failed to win the support of a majority, not of the employees, but of the employees voting. To avoid an unfair labor practice ruling, the employer has to, among other things, be very circumspect in how it responds to union charges, assertions, and accusations during the period leading up to a certification election. The employer who threatens is seen to be in violation of fair labor practices by engaging in a threat of force or reprisal. The Board is much more tolerant of union communications to employees. Furthermore, if a union is found to have engaged in unfair labor practices, the Board will seldom reverse an election that the union has won.

9. See Heldman, Bennett, and Johnson, *ibid.*, p. 43.



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The NLRB has ruled that an employer is violating employee rights if he or she is engaged in conduct which, it may reasonably be said, tends to interfere with ...employee rights under the Act (NLRB). Neither the intent behind, nor the success of, an employer's supposed violation of employee rights is relevant according to NLRB rulings - rulings that have defined employee rights, as contained in Section 7 of the NLRA, very broadly. Although the Taft-Hartley Act attempted to provide employees the same protection against unions as the Wagner Act had provided against employers, in practice the unions are given much more latitude than are employers in this regard. For example, the refusal of an employer to bargain with a certified union constitutes a *"per se"* violation of employee rights. This is seldom the case if a union refuses to bargain with an employer.[10]

Even without the threat of unfair labor practice charges, the deck has been stacked in favor of unions by NLRB rulings, rulings which in some cases override the obvious intent of Congress. Congress clearly state in Section 9 of the NLRA that, in a union certification election, it is the number of employees in the unit which is relevant in determining whether or not a majority favors the union. Yet, over the years the Board has chosen to ignore this express language and has ruled that it requires only a favorable vote from a majority of those voting in order for the union to win. It is not hard to find examples of the union being certified the exclusive representative of all the employees when as few as 20% of the employees actually voted for the union.

Even the seemingly innocuous requirement imposed by the Wagner Act, that the employer "bargain collectively with representatives of his employees," has been used to favor the short-run interests of union officials and organized workers. First, it was not even suggested that a corresponding requirement applied to unions until, twelve years after it was enacted, the Wagner Act was amended by the Taft-Hartley Act. But more important than what the legislation actually says is how it has been interpreted and used. The Congressional debates over the Wagner Act indicate that Congressmen either

10. Heldman, Bennett, and Johnson, *ibid.*, p. 50.



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did not intend, or were reluctant to admit they intended, that the collective bargaining requirement aimed at any particular pattern of outcomes. Rather, the stated intent was that of establishing a process which facilitated bargaining between employers and employee representatives. This is reflected in the statement in 1935 by Senator Walsh to the effect that the intent was to "escort representatives to the bargaining door, not control what goes on behind the door."[11] Unfortunately, the impartiality suggested here is not in the least indicative of how the collective bargaining requirement has in fact been interpreted.

For example, bargaining is supposed to take place in "good faith."[12] While few will fault the spirit of good faith bargaining, fewer yet have any idea of how to define operationally such a nebulous concept in an impartial way. Impression breeds on itself: The NLRB determined that ascertaining whether or not good faith bargaining has been violated requires looking at the circumstances reflecting respondent's bargaining frame of mind. This attempt to look at reality as opposed to rhetoric has given the Board wide latitude to rule that bad faith has occurred when bargaining does not proceed in ways which members of the Board find agreeable. That this latitude has been used primarily against employers can hardly be considered debatable, even by committed advocates of unions. As a case in point, a company finding itself unable to reach agreement with a union's international negotiators made a proposal instead to the union locals, and as a consequence was found to have acted in bad faith. The firm that has reached an impasse in bargaining with a union is still obligated to make some reasonable effort in *some* direction to compromise his differences with the union. Employers have learned through sad experience that this means yielding to union wage demands beyond the point warranted by the long-run interests of all concerned, since doing so is often less costly than facing the "remedies" the NLRB is prepared to impose on those with an "anti-union animus."

Government has gone far beyond its traditional, and proper, role in the area of labor relations. Rather than refereeing a process

11. Quoted in *ibid.*, p. 62.

12. This language did not appear in the statutes until the Taft-Hartley Act, but the NLRB preceded the Taft-Hartley Act in using and interpreting this malleable concept.



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which, in the long-run, serves to benefit workers (unorganized as well as organized), investors, and consumers alike, the government has in effect decided that workers are the underdogs, and the subset of these workers who are organized should receive privileges not available to others. The short-run effect of this perversion of the rule of law is to benefit a small minority of the work force at the expense of all other actors in the productive process. The long-run effect is to reduce the time horizon relevant to investment decisions and to reduce the economic well-being of all our citizens.

**Political Activity of Unions**

Political actions in support of labor unions both reinforce, and are reinforced by, labor union support of particular political actions. Unions have been very effective at influencing the political process in support of legislation which increases the control of organized labor over business decisions.

The explanation for the political influence of organized labor is two-fold. First, labor unions are organized around a few major concerns, the short-run wage and fringe benefits of their members being one of the most important. It is well known that narrowly focused groups (typically those oriented around an occupational or professional interest) tend to be more easily organized and more effective politically than are those with a multitude of dispersed interests (e.g., consumers).

Second, political action is most successful when organized self-interest is able to masquerade behind the rhetoric of a noble purpose. And it would be difficult to find any group which has been more adept at disguising narrow self-interest with the mask of public interest than organized labor. Unions have been very successful at using the political process to increase the incomes of their members at the expense of workers in general, while maintaining the pretense that unions are struggling for the well-being of all workers.

The success of this pretense is derived largely from the fact that organized labor has been able to project the image of a movement dedicated to the protection of worker rights against the arbitrary



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power of big business.[13] Union-supported legislation that restricts the discretion of capital owners, or their representatives, is often politically popular because it is perceived as a justifiable means of curtailing exploitative business practices. Surely, this explains much of the political appeal of minimum wage laws, maximum hour restrictions, and other legislation which limits the ability of employers to contract with employees. The distrust of big business has also been an important factor in much of the regulation government has imposed on business beginning with the Interstate Commerce Act in 1887 and continuing through to the myriad of regulations which characterize the current business environment. But regardless of why such legislation has been enacted, the result has been the same. It has created a setting in which nonunion workers are restricted from competing with union workers either directly by offering to work for less, or indirectly through the emergence of nonunion competitors to existing firms. This increases the ability of unions to extract short-run wage and salary concessions at the expense of long-run considerations of capital investment and productivity.

Organized labor has also been active in support of political measures to limit corporate practices which serve to motivate corporate managers to pay attention to the long-run. As we have previously discussed, arrangements which facilitate takeovers and mergers increase the pressure on management to consider the future consequences of current decisions. Compensation schemes such as stock options and bonuses perform the same function. The innovation of such arrangements has evolved over time as those firms that provide the most effective incentives for maintaining long-run productivity find their viability enhanced and their mode of operation imitated.[14]

13. In fact, the real battle that unions wage for their members is not against business, big or otherwise, but against other workers who are anxious to work in union jobs for less than union scale. Indeed, in the political arena, organized labor and established business interests are often working on the same side of the fence, both supporting legislation which restricts the options of unorganized workers and potential competitors to existing firms.
14. An example of such an innovation is the compensation of executives whose jobs are terminated as a result of a successful takeover or merger. It has been argued that these "golden parachutes" provide incentives for corporate executives to take risks more in line with what their diversified shareholder would consider appropriate, and not to fight takeovers that would be in the shareholder's interest. See Dennis Carlton and Jeffrey



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Not surprisingly, organized labor has generally supported legislation which restricts mergers and hampers takeover attempts. Union leaders are also quick to make a political issue out of bonus or stock option plans for corporate executives. The zero-sum fiction plays well politically that "fat cat" corporate managers are arbitrarily confiscating money that could, would, or should otherwise go to more deserving recipients (preferably unionized workers). Consider the current tax "reform," or Deficit Reduction Act of 1984, which singled out for an extra tax burden executive pay resulting from a change in corporate ownership.[15] The question as to how influential organized labor was in support of any particular provision of this tax bill is, of course, debatable. But union support for political restrictions on management compensation clearly exists, and is influential.

The effect of union-supported restrictions of this type on corporate management is to reinforce the myopic thrust of union bargaining by shortening the time horizon of corporate management. Anything that reduces the incentive for corporate managers to value the future has the effect of lowering their resistance to union demands and increases the vulnerability of capital to these demands. The tax which short-sighted union demands imposes on business capital is just as destructive of economic productivity as are the taxes which government imposes on capital.

**Unionize Now, Stagnate Later**

The effect of union myopia on future productivity can be expected to show up in two ways. First, in anticipation of a union's negative impact on the return to capital, one would predict that the projected equity value of a newly unionized firm, or one threatened with unionization, will fall. Second, in those industries in which union power is strongest, one would expect that wage demands will eventually reduce the industry's competitiveness and, in the absence

Perloff, *Modern Industrial Organization,* Harper Collins, 2nd edition, 1994, p.41. But independent of whether or not golden parachutes do improve incentives, the important point is that they, like any innovation, are best evaluated in the market place. The value of new corporate arrangements will certainly be more accurately assessed by competition in markets than by politics in Congress.

15. See Graef S. Crystal, "Congress Thinks It Knows Best About Executive Compensation," *Wall Street Journal*, July 30, 1984.



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of government bailouts and protections, push it into serious decline.

The best measure of the future profitability, appropriately discounted, of a firm is given by the value of that firm's stock, assuming it is being bought and sold in an organized and open market. If a current decision is expected to reduce the future profitability of a firm, this will be reflected in an immediate decline in the price of the firm's stock. Two M.I.T. economists, Richard Ruback and Martin Zimmerman, accordingly examined the impact on the price of a firm's stock caused by the filing of a union election petition and then by the results of that election. Based on data from 1962 to 1980, Ruback and Zimmerman concluded that, on average, a successful union drive against a firm lowers the price of the firm's stock by 3.84%. This corresponds to an average loss of $46,800 per worker employed by the unionized firms.[16] This evidence reflects clearly the ability of unions to impose a tax on capital.

There are no economically neutral taxes, whether government-imposed or union-imposed, and investors will respond to the union confiscation of capital returns. This investor response will necessarily reduce the efficiency of the unionized firm, or industry, although the exact form of the response is difficult to predict *a priori*. On the one hand, the reduction in returns to current and potential investors reduces the industry's investment appeal. This consideration suggests that capital formation will be retarded by the effects of unionization. Also, with profitability affected adversely by unions, internal financing of capital will be hampered.

On the other hand, one way to reduce the burden of union wage demands is by substituting capital for labor. And, indeed, one can be sure that the *ratio* of capital to labor will, over time, increase in response to excessive wage requirements. Whether or not this substitution effect will motivate an absolute increase in the amount of capital is not clear *a priori*. If, as is likely, the industry declines, or fails to grow as rapidly as otherwise, because of the union, then the capital-labor ratio can be increasing while the level of capital formation is being retarded. But, even if the amount of capital in the

16. Even the threat of unionization in the form of an unsuccessful union effort results in a 1.32% decline in a firm's stock price, or a $7,400 loss for each employee. See Richard S. Ruback and Martin B. Zimmerman, "Unionization and Profitability: Evidence from the Capital Market," NBER Conference Paper; Cambridge, Mass.: May 1983



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industry actually increases, it will be the result of a union-induced distortion in the capital-labor mix which will reduce both the efficiency of the industry and its ability to compete.

The evidence strongly suggests that an industry which becomes subject to a virtual union monopoly over labor is on its way to becoming a sick industry. When a union has the power to do so, it will obtain wage and benefit packages for its current members which cannot be sustained and, indeed, will mean less opportunity for future employees. The U.S. steel and automobile industries are notable examples. Both industries require large amounts of long-lived and immobile capital which are subject to exploitation by powerful unions. Not surprisingly, these industries have been confronted with industry-wide unions which, for several decades, have presented management with an effective labor monopoly. The result has been labor costs which, when measured against productivity, have been and are substantially higher than those faced by most other U.S. industries or by foreign automobile and steel producers.

The long-run impact of these excessive wages is perfectly predictable. Capital formation has lagged in the U.S. steel industry, with outdated and inefficient equipment and techniques still being widely used. Without political protection against foreign competition (provided through such devices as direct import restrictions, tariffs, or "domestic content" requirements), the technologically backward U.S. steel industry would be in even worse shape than it already is. The U.S. automobile industry has managed to maintain a technologically more current capital base than has the steel industry, although car makers also have lagged the foreign competition in important ways in this regard. The auto and steel industries are unfortunately not the only examples of short-sighted union demands contributing to the decline of basic industries and to shrinking employment opportunities for union members in those industries. The railroad and the rubber industries also might be cited as evidence of the long-run effect of strong labor unions on economic productivity.[17]

17. Obviously union demands are not the entire explanation for the decline of heavily organized industries. The myopia of labor organizations imposes a heavy tax on these industries. This is only one source of the tax burden which U.S. business must shoulder. But many of the other tax burdens enjoy the active political support of unions and their allies.



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The union myopia which motivates excessive wage demands has been detrimental to the long-run well-being of all interests in the economy-consumers, providers of capital, and employees alike. But this economically destructive short-sightedness is the completely predictable consequence of political action which increases the power of unions over business decisions and over the allocation of business profits. Political attempts to rescue unions from the plight in which they find themselves, attempts which ordinarily involve granting them yet more power and imposing yet more restrictions on business decisions, will prove just as self-defeating in the long-run as have previous attempts.

## Conclusion

We have examined a form of capital taxation that is seldom recognized as such. Government, by granting privileges to the minority of workers who are organized into unions, imposes a tax just as pernicious in its effect on capital formation as is any explicit tax. This is explained by the fact that the incentive structure of union organizations motivates myopic decisions. This is in contrast to the incentives built into the structure of private firms and corporations, incentives which reward those who give appropriate attention to the long-run consequences of current decisions.

As long as owners and managers of private businesses are free to allocate revenues between shareholders, employees, and capital investment in response to market forces, decisions will be made that promote capital formation and lead to long-run economic growth. Unfortunately, government regulation of labor relations has increasingly usurped business control over decisions relevant to capital investment, and passed that control to union officials. The result has been to lessen the attention business decisions pay to the future, to substitute excessive wages for appropriate capital investment, and to reduce the competitive vitality of major U.S. industries.

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# The Philosophy of Nationalism

*Charles C. Josey*

"Nationalism" is perceived as a controversial ideology in contemporary political science. But although it has retreated in the West, it remains a strong force in post-Soviet eastern Europe, and is still paramount in Japan, China, India and most parts of Asia, Africa and Latin America. As such, its mechanism and ideals deserve deeper study. This book provides a valuable insight into how "nationalists" think and feel about their role in relation to the world community.

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# Why the Break-up of Conglomerate Business Enterprises Often Increases Value

Edward M. Miller
*University of New Orleans*[1]

Recently, throughout the world, the news has been filled with reports of corporations breaking themselves into parts. In the United States, the largest breakup ever (in dollar value) was recently announced. This was the decision of ATT (American Telephone and Telegraph), America's largest telephone and telephone equipment manufacturing equipment company, to break itself into three parts (Church, 1995). Frequently, after such a split the parts are worth more than the whole, and this will probably be the case here.

Conventional financial theory has been unable to fully explain this because the mainstream theory incorporates a belief in "value additivity". Value additivity holds that the value of two cash flows will be the sum of the values of the separate flows. However, the theoretical arguments for value additivity are surprisingly weak, depending on certain unrealistic, but traditional assumptions in theoretical finance, including a lack of disagreement among investors, and certain assumptions about short selling. Even if these assumptions are reasonable (and they are not) for the U.S., they are not reasonable for many foreign countries where information is worse, and markets further from the economist's ideal.

Empirically, value additivity conflicts with certain observations, notably the discounts on closed end funds and the wealth creating effects of corporate spin-offs. These effects can be explained by a theory in which different assets appeal to different clienteles, with the prices being set by the clientele that places the highest values on the assets.

This paper will propose an alternative theory in which securities appeal to various clientele groups. In this alternative, differing types

[1] Address for correspondence: Edward M. Miller, Professor, Department of Economics and Finance, University of New Orleans, New Orleans, La. 70148. Tel: 504-286-6913. Fax: 504-286-6397. E-Mail emmef@uno.edu.



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of investors value different streams of cash flows differently, and prices are set by the investors who will pay the most for particular streams. After explaining the theory, its predictions will be contrasted with those of value additivity. The clientele theory will be shown to be able to explain closed end fund discounts, and the gains from corporate spin-offs and other corporate reorganizations. These better explanations reveal profit opportunities for portfolio managers. Finally, the error in traditional academic arguments for value additivity will be explained. This order of presentation will be used because many readers are more interested in having useful theory, than in criticisms of academic finance. But yet these arguments must be dealt with since a belief in value additivity prevents considering clientele effects on security prices. Some concluding remarks will then be made.

**Clientele Effects: An Alternative Theory**

The alternative hypothesis proposed here is that different securities appeal to different investors. Some investors' desired holdings of a particular security are zero at the current market price. Their bids for packages of securities that include securities they would not purchase at current prices, will be less than the sum of the market prices of the parts.

However, the major reason for investors disagreeing about the desirability of securities is heterogeneous expectations. Estimating cash flows is difficult, and estimates differ. Investors' estimates are frequently such that they choose to hold securities that other investors, similarly situated, are selling. The investors willing to pay the most for a stock are normally those with the most optimistic views about its future returns (see Miller 1977, 1990). Obstacles to short selling (discussed further below) prevent investors whose valuation is below the market price from affecting the price by short sales.

Also investors' non-marketable incomes create unique diversification needs, causing them to pay less for securities correlated with their other sources of income than the typical investor who lacks these other income sources will pay (Miller 1978). For instance, someone whose income comes from the oil industry might rationally avoid holding securities in that industry, since the value of such securities will be low at the very time when he would be using his savings to survive losing his job. If the package of securities offered



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him includes that industry, he must be offered a discount from the sum of the market prices to induce him to hold the package. A similar argument can apply to a pension fund covering workers in the oil business. The fund managers may want to design it for a high value when oil prices are low. This is when making additional contributions would impose a burden on the oil company, or when the company is most likely to fail, leaving its employees solely dependent on the fund for their pensions.[2]

Similarly, there may be investors whose tax situation makes certain securities unusually attractive. Such investors will hold a package with both attractive and unattractive securities only if the package's price is below the sum of the separate securities' prices. This idea lies behind Brickley & Schallheim's (1991) idea that the sacrifice of tax-timing options inherent in holding a closed end fund helps explain the observed discounts, and behind Mauer & Lewellen's (1990) similar tax based theory for spin-off gains.

Where investors agree on the cash flow characteristics (including risk) of different securities but still differ in their willingness to pay for these characteristics, combining two securities can reduce an investor's ability to obtain a preferred payoff distribution over different states of nature.

The investors who find a security attractive at current market prices are that security's clientele. The two cases discussed above, investors differing in their desires for payoffs in different states of nature and investors differing in their estimates of the payoffs themselves, can be combined into one theory. Each security has a clientele, whose investment needs and estimates of the security's return and risk (relative to those of other securities) are such that these investors choose it for their portfolio. Different securities frequently have different clienteles, as is shown by one investor including a security and another investor excluding it. Whenever securities appealing to different clienteles are combined, the market

[2] Of course, if the fund is insured, certain managers may prefer to use the insurance to protect against this risk, and actually prefer an exposure to oil prices. However, this does not alter the basic point that some investors may prefer to avoid exposure to certain industries.



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price will be lower than the sum of the separate prices (except when the combination has its own clientele.)

**A Simple Example**

To illustrate the clientele effect, suppose a single factor determines the prices of two stocks with investors' expectations about this factor differing. To be concrete, consider growth potential. This example is used because it is common to describe investment managers as either growth or value oriented. Bailey & Arnott (1986) have shown that most investment managers can be categorized as one or the other type. Suppose there are only two groups of investors, those who believe the best investment guide is past earnings, supplemented by book value and sales (value investors), and those who believe the best guide to the future is to extrapolate a firm's growth (growth investors). One stock, Value Products, is a well established food company whose current earnings are relatively small in relation to its assets, and below those it has earned in recent years. The other, Growth Drugs is a drug company which has exhibited high growth in recent years. Neither pays dividends. Both types of investors arrive at their willingness to pay in the same way, by estimating the stock's price five years from now and then discounting it to the present.

Table 1 shows the two groups' valuations. Estimated prices in five years are in parenthesis. Their current bids are this price discounted. For instance, growth investors believe Growth Drugs will sell for $240 five years from now, and will buy it if available at $100 or less.

**Table 1**

| | *Growth Drugs* | *Value Brands* | *Diversified Industries* |
|---|---|---|---|
| Growth Investors | $100 ($240) | $50 ($120) | $150 ($360) |
| Value Investors | $ 50 ($120) | $100 ($240) | $150 ($360) |
| Market Price | $100 | $100 | $150 |



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Either set of investors has enough purchasing power to absorb either firm's entire issue at the above prices. What prices will the market set?

Growth Drugs' price must be $100. Why? Only at this price do demand and supply balance. There are no potential buyers above $100. If the price were below $100, growth investors would observe the market price to be below their personal willingness to pay, and would buy. In due course, the growth investors would buy all of the stock held by the value investors. The growth investors, competing among themselves, would then bid the price up to $100 and hold it there.

Of course, this argument depends on those expecting slow growth (value investors) not selling short the drug company. Those expecting slow growth believe that in five years the drug stock will be at $120. A non-dividend paying stock priced at $100 expected to rise in five years to $120 is clearly overpriced. Its expected return is below any reasonable market rate. It should be sold if held. However, it is not a candidate for short selling. Selling short at $100 and buying back after five years at $120 is not profitable (selling for less than one buys is unprofitable). Thus, those believing growth will decline do not sell short, although they do accept offers to purchase their stock for more than $50.

A similar analysis applies to Value Brands. At $100 those (growth investors) expecting its recent trend in earnings to continue find the stock overpriced. They neither hold it nor sell it short. Competition among those expecting a return to historical earnings holds the stock price at $100.

Now let us consider the equilibrium prices for a closed end fund, or a conglomerate. where one share of the fund represents one share of Growth Drugs and one share of Value Brands. Value additivity theory suggests the equilibrium price for the closed end fund will be merely the sum of the prices of the two securities, or $100 + $100 = $200. However, the equilibrium price cannot be $200. There are no investors willing to pay that much for the fund. Those who extrapolate growth will pay $150 for a fund share. They arrive at this figure by noting that it gives them a claim on a drug company share, viewed as worth $100, and a claim on a food share, viewed as worth $50. The two together are worth $150. Value investors do their



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calculations and similarly arrive at a valuation of $150. Thus, both groups of investors are willing to pay $150. The price cannot exceed this figure, since no offer exceeds $150. The price will not be lower, since enough investors are willing to pay $150 to absorb the supply.

Thus, we have provided a very plausible example of the whole being worth less than the sum of the parts. Assumptions were merely current less than perfect U.S. short selling procedures and investor disagreement. These assumptions resemble reality more than the traditional assumptions: perfect capital markets, unlimited human data processing ability, and perfectly informed investors. As will be seen, closed-end fund prices and gains from spin-offs are consistent with the clientele theory, but not with value additivity.

**Testing the Theories**

Most discussions of value additivity either assume it to be true or attempt to derive it from other more fundamental assumptions. However, it is a testable theory, whose implications should be compared with the available evidence. Fortunately, there is considerable evidence available on what happens to market prices when cash flows are merged or split up. This evidence conflicts with the predictions of value additivity, but is consistent with the clientele theory.

Testing value additivity requires finding prices for cash flows sold separately, and comparing these prices with quotations for the same cash flows sold as a unit. There should be no difference. Such tests are hard to carry out because quotations on the separate parts usually are not available after mergers. However, there are situations in which market quotations can be obtained for the sum of a set of cash flows, and for the flows separately. One is for spin-offs in which a company divides itself into two publicly traded segments. Quotations are available for the stock both before and afterwards. The reverse is for mergers, where a firm is combined with another firm. Another is for closed end funds, since quotations are available both for the stocks held, and for the fund as a whole. Let us examine these cases, starting with closed end funds.

**Closed End Funds**

Closed-end investment funds are investment companies that hold a portfolio of traded shares and bonds. These should sell for



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their net asset value according to value additivity. However, these usually sell substantially below net asset values. A detailed review of the discounts and proposed explanations is not needed, since Anderson & Born (1992) provide a book-length review. The most recent contributions is an argument (Barclay, Holderness, & Pontiff, 1993) that large block holders receiving private benefits block actions which might eliminate both the benefits and the discounts.

If closed end funds truly sell for less than the sum of their parts, their owners could be made better off by liquidating the funds, or by converting them to mutual funds. Observation confirms this prediction. There has been a steady stream of closed-end fund liquidations. Announcements have been accompanied by immediate price increases, showing the discount was real, and not merely because net asset values exceeded true liquidation values (Brickley & Schallheim 1985). Additional evidence that value additivity does not hold is provided by the observation that the sum of Americus Trust primes and scores sold for more than the value of the shares on which they were based (Jarrow & O'Hara 1989).

**The Valuation of Conglomerates**

Earlier, in the discussion of the Value Brands and Growth Drugs case, it was suggested that the tendency for the whole to be worth less than the sum of the parts should apply not only to closed end funds, but also to conglomerates. Just such an effect has been found by Lang and Stulz (1993). They computed the ratio of the stock price to an estimate of the replacement value per share of the firm's assets (Tobin's q) for conglomerates and for firms that were in a single industry (four digit SIC level), and found that Tobin's q average 1.53 in 1984 for firms in only one segment, versus .91 for firms in two or three segments, .77 for firms in four segments, and .66 for firm's in five or more segments. Notice this result seems to be implying that for similar levels of assets, the diversified firm would be worth only half what the single segment ("pure play") firm would be worth. Similar results were found for other measures of diversification, and for other years.

To control for the possibility that the more diversified firms were in different industries, combination of pure play firms were constructed to give the same industry mix as the diversified firms.



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Again, diversified firms were found to sell for less than undiversified firms. Lang and Stulz assume that stock values reflect the capitalized values of future earnings, but diversified firms have lower expected future earnings. This is possible, and may be part of the explanation. However, another possibility is clientele effects. Investors differ in their opinions and prefer pure plays, avoiding diversified firms where they would have to take a stake in ventures they were less optimistic about. This possibility is not discussed.

If the market undervalues conglomerates and other diversified firms, it will value less acquisitions that add to the firm's diversification than those in industries the firm already is in. Morck, Schleifer, and Vishny (1990 confirmed this prediction by showing that acquisitions that were outside the acquiring firm's primary business lowered the parent firm's value while acquisitions in the main business raised it, although the effect was not quite statistically significant when the seventies and the eighties were combined. With a more powerful regression test, the effect of acquiring in a different four digit industry was significant at the 10% level for the eighties. When the degree of similarity was measured by the three year historical correlation coefficient between the returns of the acquiring and acquired firms, the effect was significant at the 5% level in an equation controlling for the three year growth of the acquiring firm relative to its industry.

While the paper's authors explained their results by managers making (for their personal reasons) stockholder wealth diversifying mergers, the result is as predicted by the clientele effect model. Notice the two effects are not mutually exclusive, since without managerial mistakes there might not be many opportunities to observe the value reducing effects on the acquiring firm's market value of merging firms from different industries. In the author's interpretation, the wealth reducing effects of diversifying mergers results from the managerial difficulties of running a diversified firm, while in the clientele effect case they result from reluctance of investors to hold a combination of assets, some of which they would not otherwise hold.

LeBaron and Speidell (1987) developed a model for estimating the value of divisions of multi-industry companies (essentially from the values of single play companies). The sum of the values for the firm's divisions was divided by the company's actual market value to



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give a ratio of the theoretical to market values. This was found to increase for the number of different industries the firm was in (measured by the number of different business segments the firm reported financial results for). The resulting ratio (taken from their figure 3) was lowest (under 1.3) for industries reporting only one segment, and highest for industries reporting being in over three industries (1.7-1.8). In other words, it appeared that the typical multi-industry firm would be worth about 50% more if broken up into its component businesses.

**Spin-Offs**

Spin-offs provide another opportunity to obtain price quotations for a whole and for each of the parts. Spin-offs regularly increase stockholder wealth.[3] Hite & Owers (1983, p. 430) summarize their research as that spin-offs "could generate gains roughly equal to the value of the divested unit", suggesting that "the market value of the parent's equity is hardly diminished, even though assets are distributed to the subsidiary." As they themselves note, "The gains seem quite large, to be explained by the savings from using separate specialized contracts in which the parent and subsidiary have comparative advantages," the academically preferred explanation. Schipper & Smith (1983) report similar gains. Efforts have been made to explain the gains from spin-offs. Both Hite & Owers, and Schipper & Smith consider the possibility (Galai & Masulis 1976) that spin-offs reduce the assets backing the firms' bonds and transfer wealth from bond holders to equity holders, but find no evidence of bond holders being made worse off.

Separating operations in different industries might permit better and more specialized management, or incentive managerial compensation plans related to stock prices. Ravenscraft & Scherer (1987), drawing on both interview evidence and statistical studies, show that spin-offs frequently raise the spin-off's profits. While a single management team can be at a disadvantage in overseeing several different businesses, most managerial specialization economies could be

[3] Boudreaux 1975, Hite & Owers 1983, Kudla & McInish 1983, 1988, Schipper & Smith 1983, Miles & Rosenfeld 1983, Rosenfeld 1984.



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obtained by each subsidiary having a separate management team. Indeed, if the operation remained a subsidiary, the parent's concentrated ownership would appear to permit more efficient monitoring than numerous uninformed stockholders could perform.

Evidence is now quite strong that stock in small firms is valued at less than that of large firms (for instance, Keim 1983). A spin-off typically creates a much smaller firm, with higher transaction costs and less liquidity. Thus, the gains from improved contracting and management appear unable to fully explain how assets can be spun-off without perceptible effects on the parent's stock price (as was reported for small spin-offs).

Very closely related to complete spin-offs are equity carveouts where only part of a subsidiary's stock is sold to the public. Schipper & Smith (1986) have shown that announcement of carve-outs are accompanied by an average increase in the parent's stock price of just under 2%, a strong contrast to the typical price lowering effect of announcing a stock sale. Although a 2% stock price gain appears small at first glance, it is large relative to the value of the subsidiary interest being sold, which was reported to have a median value of 8% of the parent's value. This wealth increase represents either a belief that the carve-out was actually going to raise the subsidiary's value, or more plausibly, the effect of selling part of the subsidiary for more than it contributed to its parent's value. The latter interpretation would violate value additivity, but is consistent with clientele theory.

**Clientele Effects And Spin-Offs**

Clientele theory provides an alternative explanation for how spin-offs increase wealth. They permit each part's price to be set by the investors who value that part most, without these investors having to purchase parts they value less highly. Yet, authors trying to explain gains from spin-offs appear unaware of possible clientele effects, even though much of their own evidence can be used to support it.

An early example illustrating how different clienteles for different parts of a firm may exist is provided by the LTV takeover of Wilson followed by its division into three parts, Wilson & Company, Wilson Sporting Goods, and Wilson Pharmaceutical & Chemical. Sales of minority interests in the three companies brought in enough cash to pay much of the acquisition costs. The clientele theory explains why this worked; stock in each company appealed to



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those most optimistic about the subsidiary's industry. Wilson Sporting Goods was a "pure play" in the then fashionable leisure industry, Wilson Pharmaceutical & Chemical was in the growing drug business. Both appealed to investors convinced that these industries had bright futures and hence deserved high price to earnings ratios. As Sobel (p. 95) put it "Almost immediately Sporting Goods and Pharmaceutical & Chemical became semiglamour issues, and their stocks took off." Wilson & Company, the heart of the original firm, remained an old line meat packing firm which appealed to its traditional clientele, those who thought a major meat packing firm was a desirable investment (perhaps because it was viewed as a safe defensive stock).

Increasing stockholder wealth by marketing to a new clientele group is usually not a stated reason for a spin-off (see Schipper & Smith, 1983, Table 8, Hite & Owers (1983, Table 1) or equity carve-out (Schipper & Smith 1986, p. 171). However, it does not follow that just because this reason was not stated, that it did not play a role (and, of course, even when spin-offs are not motivated by clientele related effects, this does not imply that the observed wealth increases do not result, at least in part, from such effects). Managerial incentives are to state only certain reasons for spinoffs.

Firms prefer that a spin-off be treated as a tax free reorganization rather than as a taxable dividend. Experts (Haran 1990) urge writing the legal documents to encourage this result. One of the requirements for a tax free distribution is that the reorganization have a business purpose, rather than merely a shareholder purpose. Taking advantage of clientele effects would appear to be a shareholder purpose, rather than a business one, and firms naturally prefer to emphasize improving management or similar business purposes. Public pronouncements must be consistent with the legal documents. In addition, indicating that stockholders are expected to promptly sell off distributed stock makes the distribution sound more like a taxable dividend, than a mere reorganization of the stockholders' ownership interests, increasing the probability that the spin-off might be ruled to be a taxable dividend.

There are security "marketing" reasons for management to conceal their true motives. Consider a firm having a solar energy division when solar energy is fashionable (The author has in mind the Imperial Industries' spin-off of part of its solar operations, although



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of course he has no actual knowledge of its management's reasoning.) Suppose that it announced that its solar heating division had poor prospects (perhaps because solar energy is uneconomic), but that uninformed investors would overpay for a spinoff? Announcing such a low opinion of the assets spun-off could lower the price stockholders receive for their new stock (as well as hurting solar equipment sales and demoralizing management). Few sellers of anything start the sales process by announcing that what is being sold is not worth what they expect to receive for it. There is no reason to believe managers of divesting firms would make this mistake.

Some of the justifications for equity carve-outs that Schipper & Smith label "Improving investor understanding of subsidiary," a motive mentioned in 14 out of 59 carve-outs, appear to be attempts to exploit a subsidiary's attractiveness to a particular clientele (see examples on their p. 174). They document that after the carve-out, the subsidiaries's price earnings ratios were appreciably above those of the parent firms, a finding they interpret as evidence of the subsidiaries's good growth opportunities. Although the subsidiaries probably did have good growth opportunities, an alternative is that the subsidiaries were in then fashionable businesses, ones the public would pay very generously to participate in.

Schipper & Smith describe how National Patent Development created Interferon Sciences to finance development of their interferon technology. A contribution of basic patents and technology with a book value of $.20 per share was followed by selling 25% of the new operation to the public at $10 per share. An obvious explanation (although not mentioned) is that the public valued participation in the "sexy" interferon business at more than the parent company did. The parent company hence sold it to them. They go on to say (p. 171): "Thus, Interferon Sciences represented primarily a growth opportunity, with virtually no assets-in-place. Other projects include Atlantic City casinos (two carve-outs), Hawaiian condominiums (one carve--out), oil drilling (one carveout), and bio-engineering products (one carve out). In each case, the parent firm rejected the option of funding the project by issuing parent equity and chose to offer separate equity claims on the growth opportunity by means of a carve out."

An immediately following footnote states, "There is tendency for sample subsidiaries to belong to industries that, at the time of the



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equity carve-out, were expanding relatively rapidly (e.g., gambling, health care, sporting goods and games, home video and biotechnology)." An obvious alternative explanation for not using the parent's equity is that the opportunity was thought to be a poor investment. Funding by a public stock sale was possible because these were "fad" industries, which some part of the public would to pay high prices to participate in (as evidenced by high price earnings ratios).

**Evidence for A Clientele Effect**

Shipper & Smith (1983, p. 462) document that in only 21 out of 93 spin-offs is the parent in the same broadly defined industry as the spin-off, which they interpret as supporting their hypothesis that spin-offs alleviate "diminishing returns to management which arise with expansion in the number and diversity of transactions under one management" (p. 464). The largest spin-off gains occur from divesting "units with diverse activities not closely related to the primary business lines" (Hite & Owers 1983, p. 432). Likewise, operations sold are frequently in different industries, and often in industries with quite different characteristics, than the parent (Ravenscraft & Scherer 1987).

While the difference in industries between the parent and the operation sold or spun-off is certainly consistent with managerial specialization, it is also consistent with the clientele for the divested assets differing from the parent's clientele. Security analysts frequently forecast sales, prices, and costs for a particular industry, and then use these to forecast particular firms. With this method of analysis so common, ownership will come to be concentrated in the investors with the most optimistic (relative to other industries) expectations for that industry. It follows that the current owners of stock in a particular industry will have, on average, somewhat lower expectations (risk adjusted) for most other industries. If not, they would sell this industry to buy more of the other industry. Their expectations for another industry's income stream will be below that of the home industry's price setting investors. If assets were priced separately, the first industry's owners would be willing to sell them at less than the market price. Thus, spinning-off operations in other industries could frequently raise market value.

In the standard value additivity model with homogeneous



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expectations, who makes the cash flow estimates is not important. All estimates are equal. In contrast, if estimates vary, whether to divest will depend on whose valuation is used. In this case, changing managers can lower an internal valuation below that of the outside world or that of a potential acquirer, causing a divesture. Ravenscraft & Scherer's (1987, p 179) equation for predicting sell-offs finds a statistically significant relationship between a new chief executive and sell-offs, a result consistent with a model where divergence of opinion plays a role, but not with the economist's model with perfect rationality and no role for personal differences.

The financial press continues to report proposals to split firms into two with comments suggesting that the parts will be worth more than the whole. A particularly interesting example of this paper's thesis is the spin-offs of stock in gold mines by no less than six firms (Atchinson 1986). Such concentration of spin-offs in a particular industry is not predicted in a value additivity based model. However, the clientele paradigm can explain it. Gold mining stocks appeal to particular investors ("gold-bugs") who will pay high prices for them (the price to earnings ratios for the five profitable operations was reported as 31, 37, 113, 59, and 36), and who appear to be different than those investors holding the parent companies (conglomerates and general mining companies). When these mining assets are part of a much larger firm, the valuation is that of investors not unusually optimistic about gold prices, or who do not desire to diversify by holding gold related assets. The contribution of earnings from gold mining to the parent firm's value is less than the same assets' market value when sold to those wishing a stake in gold.

Perhaps the strongest evidence for a clientele effect explanation for the gains from spin-offs is provided by Kudla & McInish (1988). They reasoned that if the spin-off gains arose from the separate parts appealing to different clienteles, the post spin-off value increase would be greatest where owners and non-owners differed most about values. Where valuations differed greatly, the spin-off would be followed by widespread trading, as those with a low valuation for the spin-off sold their shares to those willing to pay more for them. Thus, there should be a positive correlation between the gains from a spin-off and the increase in trading after the spin-off. A statistically significant positive correlation was found, providing strong support for this paper's hypothesis. Such a correlation is not predicted by



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alternative explanations for spin-off gains.

Evidence that investors who hold the original stock frequently find spun-off stock not worth holding is provided by Brown and Brooke (1993). Although the average number of institutional owners for the parent of a spun-off firm was 181.6, only 44.8 institutions held stock in the spun-off firm three month later. Apparently, the typical institution valued the stock received at less than its market price, or the stock would not have been sold.

Divergence of opinion theory predicts Sicherman & Pettway (1987) finding that acquisitions of operations in related lines of business will raise share prices more than acquisitions in unrelated lines.

The suggestion (Cusatis, Miles, & Woolridge, 1993) that parents and spin-offs were frequently bought because they represented "pure plays" is consistent with the clientele argument here.

Value additivity theory fails to explain the existence of corporate raiders who purchase positions in companies, and then break them up or restructure them. As pointed out below, these raiders consistently pay substantial premiums for control, so their actions can not be viewed as a mechanism that enforces value additivity. If there was some other mechanism enforcing value additivity, there would be no profits to be made in purchasing control at a premium, and then selling off assets and/or changing the firm's financial structure. Thus, the observed profitability of corporate raiding suggests the absence of other mechanisms capable of enforcing value additivity.

**The Rationale for Selling Money-Losing Operations**

It is often recommended that money losing operations should be sold to others. Ravenscraft & Scherer (1987, p. 167) working with line of business data from the Federal Trade Commission reported that the typical divested line of business had a negative return on assets in the year before the decision to divest. In their statistical study, the profitability of a line of business was the single most important factor determining whether that line would be divested (pp. 178-185). Their interviews show that low profitability played a key role in many divestitures.

Yet, as they note, this presents a problem (p. 146), "But if the would be seller sees that it can obtain no more for an ailing subsid-



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iary than the discounted present value of the profits with which it is already disappointed, and perhaps less, why should it sell it?" They point out that potential buyers may often bid less than the apparent present value of future profits because of a fear that the seller knows of non-apparent problems. Their interpretation of their results is that the buyer can better solve the problems than the seller. However, there is another possibility. The procedures used by investors to value stocks may cause a money losing operation to lower the value of the owning firm, although a rational buyer would pay a positive sum for the operation (Miller 1992).

The prices of many stocks appear to be set by investors who take the recent earnings, adjust for unusual factors, and then multiply these by a reasonable price earnings ratio for that industry. This is rational given limited human data processing abilities. When such investors set a stock's price, it is lowered by a money losing operation. Removing the money losing operation raises the stock's price.

The money losing operation will by itself have a positive price. When separate, potential purchasers see that it once was profitable and that it may again be profitable. They base their bids on the present value of anticipated profits. If future profitability is not assured, circumstances can often be imagined where it will again be profitable (higher product prices, for instance, or improved management). By standard option theory, an option on a cash flow with an expected value of zero or less may still be valuable. Any money received for the operation sold can often be reinvested in the selling firm, and the increased income will be capitalized into the selling firm's market value.

Jain (1985), after examining over a thousand sell-offs (the very large number of sell-offs is consistent with this paradigm, but not with the asset's contribution to value being equal for all firms), documents that sell-offs on average raise the stock prices of both seller and buyer, a result inconsistent with a model in which an asset's contribution to value is independent of who owns the asset. Part of the explanation is undoubtedly that certain assets are more productive when owned by one firm than by another. An alternative factor (not discussed) may involve clientele effects of the type discussed here.

Selling money losing operations may involve a conflict between the stockholders' short run interests and their long run interests. Splitting up ongoing operations will often involve appreciable costs.



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The operation may have to be offered at a discount to find a buyer (especially since rational buyers presume that any operation being sold by those knowing it in detail probably has undisclosed problems). If the operation is sold to the managers, they may have to be offered a bargain to persuade them to undertake the risk. Most stockholders might be better off if the operations worth continuing are not sold. However, stockholders who would sell their stocks before the turnaround is apparent obviously benefit from the short term wealth increase brought about by selling the money losing operations.

Thus there may be divestitures that in the short run raise stock prices, but which are not in the long run interests of those who keep their shares. This should warn against the textbook treatment of stock price maximization as the prime managerial goal. If nothing else, there are some undiscussed ethical issues regarding whether the goal should be high current prices, or high future prices.

**Value Additivity: The Theory**

Given the above evidence against value additivity, how do financial theorists justify their belief in it? That their belief is strong is shown by their reluctance to even discuss the possibility of clientele-based theories that violate it. Their belief comes not from empirical evidence, but from theoretical arguments. There are several arguments for value additivity. Mossin (1969) deduced it from homogeneous expectations, risk aversion, and no transactions costs. Myers (1968) has shown that the state preference model implies no gains from diversification. Schnabel (1992), formalizing my clientele model, shows that clientele effects can exist with short sales constraints. Galai & Masulis (1976) assuming no restrictions on obtaining prompt use of short sale proceeds, and homogeneous expectations, argues for value additivity, but show how mergers and spin-offs can shift wealth between stockholders and bondholders.

Assuming homogeneous expectations excludes the possibility of one investor being so pessimistic about the return from a security that he does not hold it when another similarly situated investor holds it. Thus, it is not surprising that models with homogeneous expectations typically predict value additivity, especially when coupled with assumptions that investors have similar utility functions. By assuming away any differences between investors that could cause violations of



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value additivity, value additivity is forced.

An apparently powerful argument for value additivity is an arbitrage one (Schall 1972), since it does not require the unrealistic homogeneous expectations assumption, or even that everyone use the same valuation procedure. He argues that if value additivity did not hold there would be opportunities for profitable arbitrage, possibly even opportunities for positive profits at zero investment and risk. For instance, if (A+B) sold for more than A and B separately, an arbitrageur might sell (A+B) short and then buy A and B separately. The resulting cash flows in all years would be zero but he would have taken in positive cash when the transactions were made. If (A+B) sold for less than A plus B separately, the arbitrageur would buy (A+B) and sell A and B short, again receiving a positive cash flow when the initial trades were made, and zero cash flows in all future years.

The basic weakness in the above argument is that the required arbitrage cannot be done because the required short sales cannot be made. Unfortunately, stock in a company division cannot be sold short if there is no traded stock for that division. Thus, arbitrage cannot show that the market value of a firm must equal the sum of its parts. Since this is such an obvious point, it will not be further discussed.

There are many other obstacles to easy short selling: difficulty in borrowing the stocks, the up tick rule, margin requirements, legal restrictions on institutional investors, risk of having the stock called back at an inconvenient time etc. Many of the obstacles to short selling affect only some investors and might be argued not to affect equilibrium prices. However, there is one wide spread obstacle to textbook style arbitrage that is not generally understood, that is exactly when the proceeds of a short sale are received.

The theoretical arguments presume that the cash flows from a short sale are received at the time of the sale. The short sale is treated as generating the same cash flows as a regular sale. Unfortunately, investors do not normally receive use of the proceeds of a short sale until after the position is closed out.

A short seller is selling something not yet owned, the stock certificate of a particular company. How can what is not owned be sold? The certificate is borrowed and then sold. Stock certificates are valuable pieces of paper and they are not carelessly lent to strangers.



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How is the lender persuaded to lend this valuable property? By requiring the borrower to put up the proceeds of the short sale as security. Thus, because of the very mechanics of a short sale, the proceeds are not available to the investor until after the sale is covered. In the case of a short sale designed to duplicate the cash flows of potential stocks of infinite life, the proceeds will *never* be received.

In practice, there is normally no interest paid on the proceeds of short sales left on deposit, except for large institutions and brokers. The lender (or his broker) is compensated for the costs of the lending process and the residual risks he undertakes by an interest free loan of the proceeds.[4] While in theory some of the effects of short sales can be achieved by using options or other techniques. Figlewski & Webb (1993) recently presented evidence, including lower returns on stocks with large short interests, that shows that the short selling restrictions do have an effect.

The importance of failure to receive full use of short sale proceeds can be seen by again considering the example above with Growth Drugs and Value Foods. Let us presume that there is a closed end fund that holds both Value Food and Growth Drugs. With full use of the proceed of short sales, one who wished to hold a stock equivalent to Value Foods could buy one share of the closed end fund, and sell short one share of Growth Drugs. The resulting position is exactly equivalent to Value Foods in its dividends. Thus, in standard theory it should sell at the same price. In theory, investors creating such positions would force the fund's price up, and Growth

[4] While the typical individual customer can not receive interest on the proceeds of a short sale, brokerage firms and institutions often are paid interest (although most institutions do not make short sales). Hanson & Kopprasch (1984, pp. 72-73) states that when brokers offer cash for collateral, interest is usually paid at 75% of the broker's call rate. Alternatively, brokers may offer securities or a letter of credit as collateral and pay the lender 1-2% (annual rate) for the service. While the difference between the above terms and receiving immediate use of the proceeds may seem minor, the power of compound interest is such that even a few percentage points difference in return compounds to a large amount after many years. Remember, to create a position equivalent to a subsidiary requires purchasing the parent, and then shorting securities believed equivalent to all but the subsidiary, and then holding this position *forever*. Small differences in interest rates make a big difference when holding forever.



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Drugs' price down until value additivity held.

In the real world, creating a synthetic Growth Drugs by buying the fund and shorting Value Foods would be unattractive. Admittedly, the combined dividend flow would be identical to that from owning Growth Drugs directly. However, the cash investment would be $150 (the price of the fund), while Growth Drugs could be bought directly for $100. Thus, there would be no one trying to exploit this failure of value additivity by buying the fund and shorting one or more of its holdings. The situation described in which a fund sells for $150, although its parts are worth $200, could survive indefinitely, unless someone could get control and force either an open ending of the fund, or its liquidation.

Actually, proponents of arbitrage pricing theory would argue that a locked-in riskless profit could be achieved by shorting Growth Drugs also, (i.e. by being long the fund, and short both parts) unless the whole was equal in value to the sum of the parts. Under Federal Reserve regulations, margin would have to be posted equal to half of the value of the total position (*without* short positions offsetting long positions). If the fund was not planning to become open ended, such a position would have to be held forever. With, at best, a finite profit in the future, and an infinite period of time before receiving it, the rate of return from this arbitrage position would approach zero. A zero rate of return would, of course, be unattractive (see Miller 1991 for a more general critique of arbitrage pricing theory based on this reasoning). Receiving some interest on the proceeds would make the profits greater, but as long as the rate of interest was less than the discount rate (as it always is), the potential profits are still finite, and the present value still zero (since the profits are still in the infinite future).

Of course, the above argument would also apply to a firm with two divisions, Growth Drugs and Value Foods. However, arbitrage would be even less plausible, since there would not be any separately trading divisional shares to be shorted. Value additivity proponents argue that in a perfect market, portfolios of other securities with payoffs identical to those of the two divisions exist and could be shorted. Yet, the transactions cost of doing so, even if possible, makes the value additivity outcome even less plausible.

If exact duplicates of each division's cash flows could not be created, probably because they had unique sources of variability, the



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proponents of value additivity would argue that investors would diversify away this non-systematic risk. They would do this by limiting their stake in the synthetic security to such a small amount that the extra risk would be offset by the added returns from the mispricing. Of course, to eliminate such mispricing, very large number of investors would have to discover the mispricing (in the limit, to completely eliminate all mispricing, requires an infinite number of such investors, an obvious impossibility). However, if constructing such synthetic securities is unprofitable (due to less than full use of the proceeds from short sales), there is no incentive for trades that eliminate the mispricing. Thus, value additivity is even less plausible where the divisions have unique variability.

Looking at the above simple case shows clearly the problems in even the most elegant versions of the arbitrage argument for value additivity. Once the apparently plausible value added assumption is abandoned, the way is open to consider the role of clienteles in security pricing. Once it is recognized that the value of a stream of cash flows depends on the clientele whose bids are setting its price, interesting ideas emerge. As discussed above, one can then understand how corporate "raiders" make their profits, and how investors may profit by identifying and buying candidates for profitable restructuring.

There are also implications for financial management which will only be mentioned here. The addition to the owning firm's value generated by a project may be more or less than the present value of the cash flows at the market interest rate. For instance, even though a project has a positive present value, it may lower cash flows in the short run, lowering the firm's market value. Of course, eventually such a project will raise the owning firm's market value, but this may occur in the future. Managers can be faced with an ethical issue as to whether to maximize current market value, or market value at a future time.

Investors aware of the above effects may look out for managements who are managing to raise the short run stock price at the expense of the long run price. Once identified, it may be best to sell now while the stock price reflects the effects of the short run price maximization.



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**Conclusions**

The theoretical case for value additivity is weak, requiring either investor homogeneity or perfect markets. A fatal objection to the arbitrage arguments is that investors do not receive proceeds of short sales until positions are closed out. Value additivity is a testable hypothesis. Tests include whether closed end fund prices equal net asset values, and whether spin-offs create shareholder wealth. Neither test supports value additivity. Thus, great care should be used before basing further theorizing on value additivity.

An alternative theory starts with investors disagreeing about each security's attributes. Some securities included in some portfolios will not be in other portfolios. Each security has a clientele who finds it attractive. Merging two securities with different clienteles implies that at least some of the security's previous owners will hold the combination at a price that is the sum of the parts' market prices. Hence the combination's market price must be less than the sum of the prices of the parts. Conversely, undoing an existing combination permits each part to be sold to its clientele, raising the total value.

This model can explain closed end funds discounts, why spin-offs raise stockholder wealth, the wealth increase when an operation is sold to another firm, and the existence of corporate raiders. Clientele theory explains why divested operations tend to be in different industries than that of the parent, why divested operations are concentrated in certain "fad" industries, why divestitures often follow changes of chief executives, and why they are of money losing operations.



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# Intelligence, Income and Ethnic Identity in the United States

Richard Lynn
*University of Ulster, Northern Ireland*

This paper presents data for average earnings, IQs and occupational achievements of 39 racial and ethnic groups in the United States. It is shown that the three measures are highly correlated. This would be expected, because among individuals, intelligence is a significant predictor of earnings and occupational achievement. Jencks (1972, p.337) has estimated that the correlation between IQ and earnings is .35 and between IQ and occupational achievement, .50. The process by which intelligence comes to be associated in the earnings and occupational achievement is that typically intelligent children do well at school and in college, and go on to obtain well paid and high status jobs.

## Earnings

Extensive data on differences in earnings among American racial and ethnic groups were collected for the first time in the 1980 census. People were asked to identify their race or ethnicity, and also to state their earnings for 1979. The data are available for a 1 per cent sample in the Bureau of the Census Public Use Microdata sample. In considering these data, my analysis is confined to native born men aged 15-54 and to racial and ethnic groups having 300 or more men in the sample. The reasons for these restrictions are that (1) many women do not have earnings or have only part-time earnings, so their earnings are unlikely to be strongly related to their ability; (2) up to the age of 24 many men are in college and so do not have earnings, and after the age of 55 appreciable numbers of men are retired and their earnings fall; this leaves the 25-54 age range as the most reliable for which to take their earnings; (3) setting the required number at 300 men gives all the major racial and ethnic groups including 30 of European origin and at numbers below 300 the data begin to lose reliability. Minor white ethnic groups with numbers below 300 were grouped into a single "other white" category, which included Croats, Rumanians, Armenians and so forth. Similarly, small Asian ethnic



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groups consist in of Filipinos, Hawaiians, Guamanians, etc. were grouped as "other Asians". There were appreciable numbers of Koreans and Filipinos in the United States by the mid-1990s, but not many native born ones in 1979 when these earnings data were collected; (4) native born men have had more or less equal opportunities to make their way in society, while foreign born men have had less opportunity to do so. For instance, Vietnamese men have earnings well below the average, but this is largely because in 1979 the great majority of them had arrived recently as refugees, unable to speak English, and only able to obtain low paid jobs, so it is unreasonable to include these in the analysis.

Respondents in the census were asked to identify both their race and their ethnicity. They were allowed to give more than one ethnicity, but in those cases were asked to give these in rank order. For instance, they might give German 1 and English 2. These individuals were assigned to their first ranked ethnic group on the assumption that most of their ancestors were of German origin, but they also had some English ancestors. Some individuals identified themselves as white race and American ethnic origin. The result of this classification was to give a breakdown into 39 different racial and ethnic groups. The average earnings of these are shown in column 1 of Table 1. Shown also in column 2 are the earnings of the groups as percentages of total American male earnings. At the top of the table the average of all male earnings is given. All these earnings figures are based on men who reported earnings in 1979 and therefore excluded the long term unemployed who had no earnings.

**Intelligence**

We turn next to the average intelligence levels of these groups. The figures for these as mean IQs based on a white mean of 100 and standard deviation of 15 are given in the third column of the Table. These figures were derived in two steps. Firstly, average IQs were obtained from the research literature for seven groups, namely all whites, Russian Jews, Chinese, Japanese, Mexicans, American Indians and blacks. These were plotted against earnings, as shown in Figure 1. A trend line was drawn and shows an almost perfect linear trend for the earnings of the racial and ethnic groups to rise with increasing IQs. The second step was to read mean IQs of the other racial and ethnic groups off the trend line. For instance, the Austrians have



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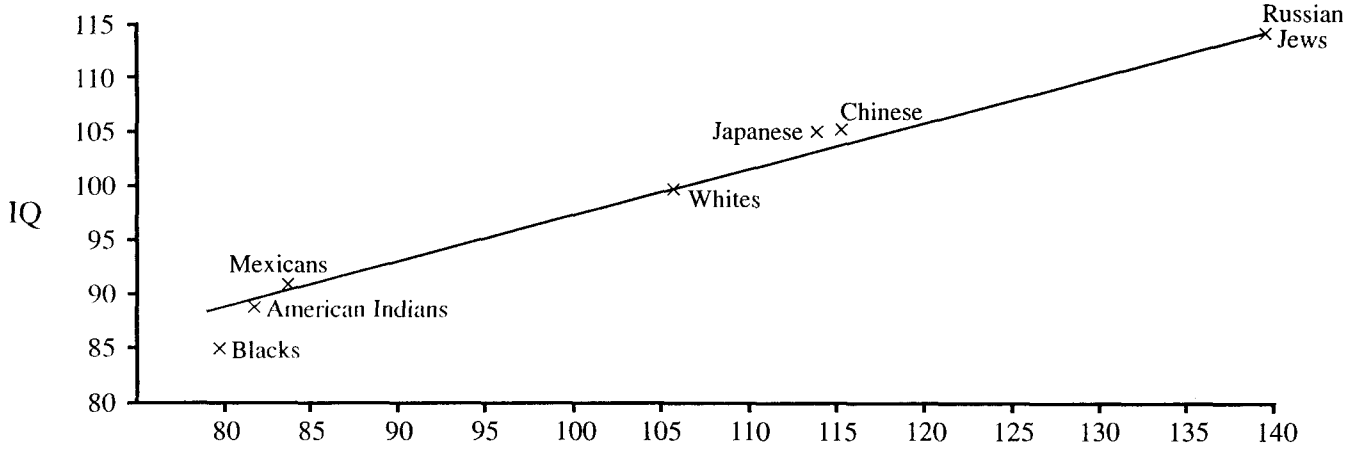


Fig. 1. Average IQs and earnings (percentage of total) of 7 American racial and ethnic groups.

Table 1: Annual Earnings of Men 25-54: Differences from the National Average, mean IQs and Performance Coefficients

| | 1979 Annual Earnings $ | Percent of Total | IQ | Performance Coefficient | | 1979 Annual Earnings $ | Percent of Total | IQ | Performance Coefficient |
|---|---|---|---|---|---|---|---|---|---|
| US Total | 23.4 | 100 | | | **White Ethnic Groups** | | | | |
| **Hispanic Groups** | | | | | | | | | |
| Mexican | 19.3 | 83 | 91 | 10 | German | 24.4 | 104 | 99 | 111 |
| Puerto Rican | 19.6 | 84 | 91 | - | Greek | 25.7 | 110 | 102 | - |
| Other Spanish | 21.3 | 91 | 94 | 10 | Hungarian | 27.8 | 119 | 106 | 88 |
| **Racial Minorities** | | | | | Irish | 24.5 | 105 | 100 | 108 |
| Amer. Natives | 19.1 | 82 | 89 | - | Italian | 25.5 | 109 | 101 | 69 |
| Black | 18.6 | 80 | 85 | 9 | Lithuanian | 27.3 | 117 | 105 | - |
| Chinese | 26.8 | 115 | 105 | 271 | Norwegian | 24.7 | 106 | 100 | 90 |
| Japanese | 26.4 | 113 | 105 | 227 | Polish | 25.6 | 110 | 102 | - |
| Other Races | 20.3 | 87 | 93 | - | Portuguese | 25.4 | 109 | 101 | - |
| **White Ethnic Groups** | | | | | Russian | 32.4 | 139 | 114 | - |
| American | 21.3 | 91 | 94 | - | Scandinavian | 25.7 | 110 | 102 | 110 |
| Austrian | 29.4 | 126 | 109 | - | Scots-Irish | 25.4 | 109 | 101 | - |
| Belgian | 27.2 | 116 | 104 | - | Scottish | 25.7 | 110 | 102 | 102 |
| Canadian | 23.7 | 101 | 98 | - | Slovak | 26.5 | 114 | 103 | - |
| Czech | 25.5 | 109 | 101 | - | Swedish | 25.6 | 110 | 102 | 117 |
| Danish | 25.4 | 109 | 101 | 108 | Swiss | 24.2 | 104 | 99 | - |
| Dutch | 23.5 | 101 | 98 | 103 | Ukrainian | 25.5 | 109 | 101 | - |
| English | 24.1 | 103 | 99 | 99 | Welsh | 25.7 | 110 | 102 | 117 |
| Finnish | 27.3 | 117 | 105 | - | Yugoslavian | 28.0 | 120 | 106 | - |
| French | 23.2 | 99 | 97 | 61 | Other whites | 24.6 | 105 | 100 | - |
| French-Canadian | 23.8 | 102 | 98 | - | | | | | |

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earnings 126 per cent higher than the American average, and this corresponds to an IQ of 109.

The basis of the mean IQs of the seven groups derived from the research literature will now be described.

1. Russians. It will be noted that the highest earning group is the Russians at 139 per cent of the national average. The great majority of American ethnic Russians are Jews who emigrated to the United States to escape the pogroms in Russia in the closing decades of the nineteenth century and up to World War I (Lieberson and Waters, 1988). Studies on the intelligence of American Jews have been reviewed by Storfer (1990) who estimates their average IQ at 112. MacDonald (1994) also reviews the evidence and concludes that the average IQ of American Ashkenazi Jews is 117. For the purposes of this paper I have split the difference and enter an average Jewish IQ of 114. This is easily the highest IQ of the ethnic groups, and also the group with the highest earnings.

2. Whites. The IQ of all the whites combined is set at 100, and their earnings are the average of the whites.

3. Chinese and Japanese. Among the non-whites, the Chinese and Japanese stand out with their relatively high earnings of 115 and 113 per cent above the all American average. The best measure of their intelligence level is obtained from the standardization sample of the Differential Ability Scale carried out in 1988, from which I have calculated their average IQ at 105 (Lynn, 1996).

4. Hispanics. The three Hispanic groups all have significantly lower than average earnings at 83 per cent of All American in the case of Mexicans, 84 per cent for Puerto Ricans and 91 per cent for other Spanish. The mean IQ of Hispanics as a single group in the standardization of the Differential Ability Scale (DAT) Hispanics is 91 (Lynn, 1996). Unfortunately there appear to be no data for the IQs of the three Hispanic groups individually. Most Hispanics are Mexicans and most Mexicans are either American Indians or of mixed European Spanish and



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native American Indian ancestry. Official Mexican government statistics state that 55 per cent of the population are Mestizo (European and American Indian mixed race), 29 per cent are pure American Indian, 15 per cent are white and 0.5 per cent black (Britannica World Data, 1992). The mean IQ of Amerindians is approximately 89, this being the median of 15 studies summarized in Lynn (1991). Hence if the Spanish are assumed to have an average IQ of 100 and Amerindians of 89, persons of Spanish-Amerindian ancestry should on average have an intelligence level intermediate between the two, and the figure of 91 obtained from the standardization of the DAT looks about right. I have therefore entered this figure for Mexicans in the Table. It is difficult to know the racial mixture of the other Spanish group of Hispanics. Most of them are probably predominantly of European stock but some of them probably have some American Indian ancestry. Puerto Ricans are mostly of mixed Spanish, American Indian and black ancestry.

5. Native American Indians. As noted, their IQ is approximately 89.

6. Blacks. The group with the lowest earnings is the blacks with 80 per cent of average earnings. Their IQ is also the lowest at approximately 85. This has been shown in numerous studies for which references are given in Lynn (1991, 1996).

**Chinese and Japanese**

An inspection of Figure 1 will show that the Chinese and Japanese have earnings slightly above the trend line. This means that they are earning more than would be expected from their IQs. The explanation for this must be that they have some other advantage for securing high earnings. Probably they work harder, in accordance with the general equation IQ x motivation = achievement, first put forward by Galton (1869) and restated by Jensen (1980). This is the same conclusion that Flynn (1991) has arrived at by a different route.

**Blacks and American Indians**

Just as the Chinese and Japanese have earnings above the trend line, so blacks have earnings below. This means that blacks do not



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earn so much as would be expected from their IQs. Some will attribute this to discrimination in employment, but another factor may be that blacks are not so strongly work motivated as whites. The pattern of results showing Chinese and Japanese above the trend line and blacks below is consistent with Rushton's (1994) theory of an Oriental-Caucasian-black gradient for non-cognitive socialization traits.

**IQ Differences among Whites**

The 31 white groups have some degree of consistency is so far as they all fall in the IQ range from 94 to 114, and therefore all have higher IQs than Mexicans (91), Puerto Ricans (91), American Indians (89) and blacks (85). It is interesting to note that the Other Spanish Hispanics with an IQ of 94 score at the lower end of the white groups with the same IQ as unspecified American whites. This is to be expected, as Other Spanish can be assumed to be largely white.

Over and above this general consistency, there is a 20 IQ point range between the white ethnic stocks, from an IQ of 114 among the Russians to 94 among the unspecified Americans. The two main reasons for these differences are probably the numbers of Jews in the groups and the operation of selective migration for intelligence among immigrants. So far as the numbers of Jews are concerned, because the Jewish IQ is about 114, any white group with appreciable numbers of Jews is going to have a relatively high IQ. The extreme case is the Russians, who are mainly Jewish. Other categories which include relatively large numbers of Jews are the Hungarians (IQ 106), the Lithuanians (IQ 105) and the Austrians (IQ 109). Possibly the Yugoslavs and Slovaks (IQ 103) include appreciable numbers of Jews, but this researcher has no data on this.

Several other of the higher IQ white groups cannot be explained by their having large numbers of Jews. These include the Finns (IQ 105), Belgians (IQ 104), Swedes (IQ 102), Welsh (IQ 102) and the Scots (IQ 102). Probably the reason for the high IQ of these groups lies in the selective migration of the more intelligent and the more enterprising from their home countries to the United States. In the case of Scotland there is substantial evidence that those who emigrated had on average higher than average intelligence, leaving behind those with below average (Lynn, 1977).



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**Occupational Achievement**

We turn now to the question of whether the intelligence levels of the ethnic and racial groups are related to their occupational achievement. Data on the occupational achievements of American ethnic and racial groups have been calculated by Nathaniel Weyl in his book *The Geography of American Achievement* (1989). His method was to take seven reference books listing high achieving individuals. These were *Who's Who, American Men and Women of Science, Frontier Science and Technology, Poor's Directory of Directors, Who's Who in Finance and Industry, The Directory of Medical Specialists,* and *Who's Who in American Law.* He allocated the entries to their group of national, ethnic or racial origin on the basis of their surnames. For instance, Cohens would be counted as Jewish, Smiths as English and so on. Next, he ascertained the frequency of these names in the population of the United States from Social Security rolls. The next step was to calculate the ratio of the numbers from each group appearing in the occupational achievement reference books to its number in the general population. Finally, this ratio was multiplied by 100 to give an occupational "performance co-efficient". A performance coefficient of 100 means the numbers of high occupational achievers the group throws up are average for the nation. A performance coefficient of 200 means that the group produces twice as many high occupational achievers as would be expected on the basis of its numbers in the population, so it is a high achieving group. A performance coefficient of 50 means that the group produces only half as many high occupational achievers as it should, so it is a low achieving group. The data were obtained for the year 1984.[1]

There are a few problems with the methodology. Firstly, a number of names cannot be clearly allocated to a national, racial or ethnic group. For instance, Lee might be a Chinese or an English

[1] It should be mentioned that Weyl's assumption that achievement was the direct result of intelligence has been criticized on the grounds that those ethnic groups which maintain a high sense of community loyalty (such as Armenians, Jews, Koreans, Chinese and Japanese, and to a lesser extent Vietnamese), and who actively assist new immigrants to obtain attractive situations within the United States economic and social framework, will tend to succeed more easily than the individual members of ethnic communities which are not bound by such traditions of communal loyalty and mutual assistance. - Ed.



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name. Ambiguous names of this kind were discarded. Secondly, the great majority of blacks have British names. To overcome this problem, Weyl uses the name Washington, which is almost invariably borne by blacks. Thirdly, not all of Weyl's groups correspond precisely with those used for income and IQ shown in Table 1. The two principal problems are (1) that Weyl has a category of Jews, which includes Jews of all national origins, whereas the category of Jews used for earnings and IQs consists only of Russian Jews; and (2) Weyl has a category of Spanish, which combines the three Hispanic groups shown in Table 1. Nevertheless, these involve only minor discrepancies between Weyl's categories and the categories used for the earnings and IQs.

Weyl's results for the overall performance coefficients, obtained by averaging the coefficients derived from the seven reference books of high occupational achievers, are shown in column 4 of Table 1. There are several points of interest. Notice first that the group with the highest performance coefficient of 488 is the Jews, who also have the highest average IQs and earnings. Next come the Chinese (271) and the Japanese (227), who also have high IQs and high earnings. All the 13 white groups for which Weyl gives occupational performance coefficients fall in the intermediate range with performance coefficients ranging from 61 for the French to 117 for the Welsh and the Swedes.

Weyl's Spanish category has been allocated to both the Mexican and the Other Spanish groups. They have a low performance coefficient of 10, and they also have low earnings and IQs. Finally, blacks have the lowest earnings and IQs, and they also have the lowest performance co-efficient of 9. There are one or two disparities between the performance coefficients of the twelve non-Jewish white groups and their earnings and IQs. The most striking are the Hungarians, who have a high IQ of 106 and high earnings, but a low performance coefficient of 88. Probably the reason for this is that Weyl's Hungarian group excludes Jews, all of whom are allocated to his Jewish category, whereas the Hungarian Jews are included with the Hungarians in the data for earnings and IQs.

There are clearly some very considerable differences between the national, racial and ethnic groups in performance coefficients. The reason for this can be understood as follows. Probably to do sufficiently well in the occupational hierarchy to be listed in one of



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the reference books of the distinguished it is necessary to have a minimum IQ of about 125. Of course, not everyone with an IQ of 125 plus gets into one of the reference books. This is because personality traits of motivation, self-discipline and the capacity to work for long term objectives are also required, and a lot of people lack these. An IQ of 125 is just one of the necessary qualities.

Now in the American population as a whole, with its average IQ of 100, 4.8 per cent have an IQ of 125 and above, whereas among the American Jewish population with its mean IQ of 114, 23.3 per cent have IQs in excess of 125. Thus Jews have 4.85 times as many people with IQs in excess of 125 as the general American population, almost identical to their 4.88 per cent excess of high occupational achievement.

Consider now the blacks with their mean IQ of 85. They have 0.4 per cent of their population with IQs in excess of 125. This is 8 per cent of the 4.8 per cent of the general population with IQs over 125, almost identical to the performance coefficient of 9, achieved by blacks in Weyl's calculations.

**Conclusions**

We have examined data for 1980 and 1984 for the earnings, IQs and occupational achievement of the major American national, ethnic and racial groups. The results hang together consistently. The Jews have the highest average earnings, IQs and occupational achievement, followed by the Chinese and Japanese; all the numerous non-Jewish whites fall in the middle range; Hispanics and blacks perform poorly in all three respects.

Demographic projections show that by around the year 2050, Hispanics and blacks combined will become a majority in the United States, as a result of high birth rates and immigration (Bouvier, 1992). When this occurs it appears inevitable that, to the extent that intelligence is inherited, the level of intelligence, the earnings and the achievements of the United States as a nation will deteriorate.

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APPENDIX: SOME CHANGES IN SOCIAL LIFE IN A COMMUNITY
WITH A FALLING INTELLIGENCE QUOTIENT
Raymond B. Cattell



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# Race Relations in America: Forty Years after the "Civil Rights Revolution"

Dwight D. Murphey
*Wichita State University*

BOOK REVIEW ARTICLE

**Paved With Good Intentions: The Failure of Race Relations in Contemporary America**
*by Jared Taylor*
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*The Washington Post*, dated 22 October 1995, has reported that following a recent Supreme Court decision, the U.S. military have decided to annul as unconstitutional a program that had been in force since 1988, by which if two more bids for military contracts were received from "minority" firms (usually firms controlled by ethnic minorities) it was obligatory that the contract be given to a minority supplier. This program ensured that contracts worth over a billion dollars a year would necessarily be given to ethnic minority business interests to the exclusion of white-controlled firms no matter who was the lowest bidder or the more efficient supplier. A strong reaction against affirmative action programs in government contracts and in educational opportunities which penalized whites in the United States is presently underway, and this is resulting in a major realignment of the U.S. political scene.

After many years of struggling together against the major trends of twentieth century welfare statism, the varying points of view that make up the American Right are experiencing splits over several issues, but one in particular will be of fundamental significance in the long term. This split is perhaps best illustrated by the article Dinesh D'Souza, the John M. Olin fellow at the American Enterprise Institute and author of the recent book *The End of Racism* which repeats many of the points made in the book by Jared Taylor that is



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being reviewed here, wrote for the Opinion section of the *Washington Post* on September 24, 1995. In it, D'Souza attacks Taylor and others (such as Lawrence Auster, author of *The Path to National Suicide*, and columnist Samuel Francis) as embracing "a new spirit of white bigotry." Why? Because they have concluded that if American civilization is to continue in anything like its past form, it is imperative that white Americans regain a consciousness of and loyalty to their own racial identity not unlike that held by people of all other ethnicities. In contrast, D'Souza calls on Americans "to unite [instead] behind a race-neutral banner."

The division between these points of view is of immense importance and should become the subject of open and reasoned debate. By participating in this debate, D'Souza renders a useful service, from which he detracts greatly by his characterization of those who disagree with him. For thinkers of the quality of Taylor, Auster and Francis, bigotry has nothing to do with it.

The issue has many facets, but the central question is one of the heart, and will unavoidably be answered, either directly or by default, by all Americans (of any race or background): Do Americans value the civilization they have had, and want to see its main contours continue into the future? Or do they place little value on it and feel themselves willing instead to see it supplanted by a civilization bearing the stamp primarily of cultures and heritages from Latin America, Asia and Africa?

To say that only the latter is a respectable opinion, and that loyalty to the civilization Americans have known is "bigotry," are assertions that in themselves demonstrate how far America has come toward the dissolution of its former identity. As recently as thirty years ago, it would have been unthinkable. America's mainstream and heritage were established facts, and hardly seemed threatened. If anyone had suggested that a multiethnic cauldron from all the nations of the world should take its place, consigning it to a reviled memory, and that anything else represents "bigotry," the suggestion would have struck most Americans as as ludicrous as it is vicious.

Along the same lines, when we refer to the "American mainstream and heritage," we again speak of something about which perceptions have undergone change. Until recently, few would have had occasion to describe the mainstream of American society in racial terms as "white" or as predominantly European in origin. People



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valued the United States and its heritage for its own sake without thinking in those terms. Accepting the continued existence of the United States as an unspoken premise, the aspiration was indeed for a society that would treat all individuals as individuals according to their particular merit. What has caused the focus to change has not been that culturally-concerned classical liberals have adopted a "racist" outlook, but that the mainstream civilization has come to be challenged by massive immigration from the Third World and by a multiculturalist ideology, occupying all the citadels of "political correctness," that exalts other ethnicities and that has launched a virulently racial attack on the whiteness of the mainstream. It is this that has forced supporters of the fast-disappearing mainstream to make articulate what was previously assumed as a given. Under these new circumstances, thoughtful people have come to think that American culture will soon be swamped out unless those who constitute the current mainstream wake up to what is happening and resolve not to let it continue by default. The "white consciousness" is forced on those who hope to preserve the culture, and they have been forced to realize – as they never had occasion to before – both that that culture has indeed been European in origin and overwhelmingly white and that a profound change from those features will inevitably alter the society beyond recognition.

This division within the Right between those who welcome, or at least are willing to accept passively, vast demographic change in the United States (and, we might add, in Europe) and those who do not marks a crisis about the very nature of classical liberalism. American "conservatism" is an amalgam of several philosophies, but major parts of it center on "classical liberalism" and favor the market economy, limited government, federalism, constitutionalism, property rights, the Rule of Law (with its equality before the law), and other hallmarks of the classical liberal tradition. These hallmarks have historically included the attributes of an "open society" on the international level as well as in the domestic society, and have included a strong commitment to free trade and open borders.

It is important to note that for thinkers who have gone into things deeply enough, the hallmarks also include a vitally significant cultural substratum: the family, internally disciplined personal responsibility, civic virtue, the work ethic, respect for property and for the rights of others, basic morality and honesty and good faith in both



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public and private matters, a shared myth relating to the society's history and ideals; and, for many but not all, strong (Christian) religious belief.

The crisis turns on whether classical liberalism is best understood as an ideology centering almost entirely on premises relating to government and the free market, or is best understood as presupposing, in addition, an advanced civilization based on the cultural factors just mentioned. In previous writings, this reviewer (who very much sees himself as a classical liberal) has argued for the latter, asserting that a free society needs an entire philosophy encompassing all of its aspects and not just a few premises stressing, to the exclusion of others, parts of the whole. It is with this in mind that I can say that when D'Souza attacks the likes of Taylor, Lawrence Auster and Samuel Francis because they seek to preserve America in some semblance of what it has been, D'Souza's classical liberalism consists of embracing certain parts of its tenets without looking to its overall health. It is like attending to a few symptoms while the patient dies. Unfortunately, a fixation on certain premises to the exclusion of the whole has become typical of many libertarian or free market enthusiasts, with the result that their philosophy falls far short of being sufficient for a free society. They have made classical liberalism into one or more narrow, fractionated ideologies, not into an overall expression of what is needed for an advanced civilization based on ordered liberty.

It is reasonable to ask which view is most consistent with the outlook of the great classical liberals of the past. If we consider Richard Cobden and John Bright, say, who led the fight for free trade in the Britain of the 1820s and '30s, we know that they enunciated a philosophy of free trade and democratic participativeness (found then in the issue of universal male suffrage) that was, by implication, highly cosmopolitan and internationalist. But their writings reflect, too, a passionate commitment to the moral and cultural foundations of society (as did Adam Smith in his *Theory of Moral Sentiments*). In his diaries, John Bright tells how scandalized he was in 1835 when he took a trip to Portugal and found that "the people seem to have no spirit nor industry. They lie about in the roads asleep in the daytime, and travelling is by no means safe in the evening." After visiting Turkey, he wrote: "No inducement is held out to the people to march on the road of civilization. There exists no spirit of emulation



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amongst them, and they drag on their existence as nearly as possible in the same listless and apathetic manner in which their fathers have done before them."[1] Are we to imagine, then, that Bright was indifferent to cultural and moral factors? An unspoken premise of his cosmopolitanism was that progressive, advanced civilization would prevail, then and in the future, at least in his own country. The idea, say, that the inner cities at the core of Britain and America's great metropolises would rot into copies of Lagos, Nigeria, would have shocked him into articulating aspects of his philosophy that, as it was, he found no occasion even to think about, much less make explicit.

D'Souza's charge of "white bigotry" raises still another issue. Are we to assume that any desire to maintain the Caucasian race and to preserve Euro-American civilization implies a malevolent intent toward other peoples? Are Taylor, Auster and Francis anti-black, anti-Asian, anti-Hispanic, or anti-anything else because they are pro-white? In today's climate, this imputation comes almost automatically, as though there were a necessary connection. It is the assumed premise behind D'Souza's attack on them, and it is exceedingly unfortunate. For the Left to assert it is predictable; for a proponent of classical liberal values to do so, tragic. As the debate goes forward, the proponents of a multicultural swamping-out of the United States and of Europe will no doubt assert (as they already do) that any policies, such as restrictions on immigration or on the welfare state, that seek to preserve the existing culture will represent "hatred" and "bigotry." Such assertions should not go unchallenged. They deny the right of a given people and a given society to exist, and are in effect genocidal. We have come so far that cultural genocide against European and American society has been elevated to the moral high ground – now voiced even by erstwhile conservatives. In fact, we are told that it is a moral crime, a despised bigotry, to voice opposition. In today's context, it takes brave men to stand out against such an *ethos*, especially since most people within the mainstream are quite content to be oblivious to the threat to their own way of life and, out of a habit of being smugly "correct," repeat inanely the shibboleths they hear from the liberal media. Taylor, Auster and Francis (and psychometric researcher Michael Levin, whom D'Souza also mentions) are brave men. Whether their voices are cries in the wilderness remains to the seen.

None of this is to say that there is no danger that a growing white



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self-consciousness might become destructive. This danger will mainly exist if the predominant white population is caused to become angry and militant. There is a vital need for that population to wake up and take a stand against the assault upon it, but care will have to be taken that this be an awakening fully consistent with the respect for individuality that is inherent in America's classical liberal heritage. The best preventative against an angry awakening lies, however, not in exhortation but in containing (and hopefully eliminating) the decay in, and attacks upon, American civilization. During the Simpson murder trial, Fred Goldman, the father of the murdered Ronald Goldman, expressed intense anger and frustration, as any father must necessarily feel when his son has been butchered. If white consciousness is to be constructive, white Americans must not be allowed to become a nation of Fred Goldmans.

On another point, it would be easy to observe that D'Souza's orientation arises naturally out of the fact that his origins are from Asia, not from Europe. But that isn't, or at least should not be, nearly so clear. Those who have in the recent past come from other cultures presumably did so because they value the civilization the United States offers. Why, then, *precisely from their own point of view*, will it be in their and their descendants' interest not to be "conservative" toward that society? If they see their interests this way, they will realize that they share the concerns of cultural conservatives; and this implies, if it means anything but a chimera, maintaining a heavy preponderance of European heritage in the United States.

In light of D'Souza's *Washington Post* attack, these thoughts have been a necessary preliminary to a review of Jared Taylor's book *Paved With Good Intentions: The Failure of Race Relations in Contemporary America*, even though that book does not take up the larger issue of preserving mainstream (white) culture. Instead, the book voluminously documents the fix America has gotten itself into regarding its black minority, both in objective fact and by adopting warped ideological perspectives. This is a more limited function, but one that gives the detail on a major aspect of the crisis. As such, it provides a necessary underpinning to the debate over the more ultimate questions. (It is odd that D'Souza, a mere three years later, has authored a book that reiterates virtually all of Taylor's points, despite disagreeing with him on the ultimate question.)

Such finite issues, relating to the quality of our lives in a civilized



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setting, are almost as important as the "matter of the heart" mentioned above. The threat that multiculturalism poses to American society is not only a threat to national identity; it is also one that has a thousand practical facets, which ought to be evaluated for their individual and cumulative effect: such matters as personal safety, the quality of education, economic productivity, the grace of life, and many others.

### The Book: *Paved With Good Intentions*

As most of us read the newspaper, we become aware of a certain bit of news, only to lose track of it as the days go by and new events come tumbling upon us. To keep track of everything and eventually to see it as a whole requires clipping most of the stories and maintaining a large filing system. Few people have the time or inclination to do that.

Here, Taylor has done it for us. He has followed contemporary American race relations by collecting over a thousand recent articles and reports (as evidenced in his 1339 footnotes). The result is a living history directly from the news pages.

There is no substitute for reading the book as a whole, since one of its contributions is to provide that documentation. In what follows, we must be content to summarize some of his main points.

### The Rise of a Black Underclass

Since the beginning of the post-World War II civil rights movement, there has been a twin development within America's black minority: a large increase in the numbers of black professionals, of which half work for government;[2] and the rise of a black "underclass" in which the standards of civilization have deteriorated badly. The collapse is manifest in many ways:

- The rates of criminal involvement, including rates of homicide and serious crime. "One in four black men in their twenties is either in jail, on parole, or on probation," Taylor says. "This is approximately ten times the rate for whites of the same age. Though they are only 12 percent of the population, blacks commit more than half of all rapes and robberies and 60 percent of the murders in America."[3]
- The criminal victimization of whites. "When whites commit violence, they do it to blacks 2.4 percent of the time. Blacks, on the other hand, choose white victims more than half the time...The



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proportion of black-on-white rapes has soared. In a 1974 study in Denver, 40 percent of all rapes were of whites by blacks, and not one case of white-on-black rape was found."[4]

- The illegitimacy rate. "In 1950, only 9 percent of black families were headed by one parent...By 1970 it was 33 percent. Now fully half of all black families with children are headed by a single parent. In 1959, only 15 percent of black births were illegitimate...By 1992, the figure was approaching 70 percent."[5]
- The syphillis rate. "From 1985 to 1990, while syphillis rates for whites continued their long-running decline, they rose 126 percent for black men and 231 percent for black women."[6]
- Rates of heroin, cocaine and crack addiction. The details Taylor gives about this are so extensive that they can't be summarized in a single quotation. Suffice it to say that an estimated 50,000 babies were born as addicts in the United States in 1989, and that "in 1989 the going rate for oral sex in one Harlem crack house had reportedly dropped to 25 cents" because of women's desperation for the drug.[7]
- Receipt of public assistance. "Blacks are more than four and a half times more likely than whites to be on public assistance...welfare, food stamps, Medicaid, and subsidized housing."[8]
- Record of failure. "At some urban high schools, nearly 70 percent fail to graduate." In school, "failure and bitterness cascades down to all levels." In business, blacks are quickly passed by other minorities: "In Miami, repeated waves of immigrants have worked hard, gotten ahead, and leap-frogged blacks."[9]

**The Changed Direction of the Civil Rights Revolution**

Whereas the "civil rights revolution" was originally accepted by Americans as a movement toward color-blindedness in which people would be judged according to their individual merit, Taylor says it wasn't long before it evolved into a movement for special group rights and became officially race-conscious. Rising black consciousness, with an increasing radicalism and paranoia, has been accompanied by waning white self-awareness. Africanism has become a cultural assertion, with bogus claims about black history; and there has even been a black-sponsored move toward resegregation. "Every morning, the students of Shule Mandela Academy in East Palo Alto, California, pledge to 'think black, act black, speak black, buy black, pray black, love black, and live black.'"[10]



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Dependence on government is a way of life. And with the rise of the underclass, the drive for "tolerance" has evolved into an insistence upon accepting intolerable behavior. All of this leads to rising white resentment, although most middle class whites go about their lives in protected compartments that don't bring them into touch with many of the problems.

**"Affirmative Action"**

When the Civil Rights Act of 1964 was under consideration, Senator Hubert Humphrey assured the Senate that it "does not require an employer to achieve any sort of racial balance in his work force by giving preferential treatment to any individual or group." To make this clear, the assurance was written explicitly into the Act. Taylor says Humphrey "even promised on the floor of the Senate that he would physically eat the paper the bill was written on if it were ever used to require corrective hiring preferences."[11]

Everyone knows, of course, what soon happened; but the value of Taylor's account is that he spells out the detail of the law's rapid evolution into quotas, preferences and set-asides in every nook and cranny of American life:

- Minority set-asides. "In 1989, thirty-six states and nearly two hundred local governments had minority 'set-aside' programs, which awarded a fixed percentage of all contracts to companies owned by nonwhites or women." Section 8(a) of the Small Business Act requires "noncompetitive, sole-source contracting for companies owned by 'economically disadvantaged' minorities" – with "disadvantaged" being defined as any contractor with "a personal net worth of under $750,000"![12]

- Special programs of many kinds. One of these, we find, has been the effort by the Big Three automakers to create black car dealerships. "They offer minorities intensive, one- or two-year programs that include classroom training...Once minorities have finished the program, the automakers finance up to 85 percent of the cost of the dealership...If it goes broke, the investment can be returned to the dealer. Whites who start a dealership lose their investment if the business fails." In such a thing as broadcast licensing, "affirmative action laws [were] passed in 1978 to encourage minority ownership of broadcasting stations ...minorities get extra points when they apply...Recently The New York Times got a $50



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million tax break because it sold a $420-million cable TV subsidiary to a group with 20 percent minority ownership."[13]

- Preferential treatment on tests. This widespread phenomenon is illustrated by the fact that on the exam the FBI gives to prospective agents, "blacks get 5 extra points because of race." "Race-norming" involves giving "blacks or Hispanics higher marks than whites for the same number of correct answers;" it is done by comparing the scores made by members of one race only to scores made by other members of the same race. Taylor says many employers welcome race-norming because it provides them an easy way to meet the racial quotas that are demanded of them.[14]
- Relaxation of standards. The unremitting drive to recruit more blacks into everything has lowered standards drastically. A striking example is that the State Department stopped expecting prospective diplomats to know a foreign language when it was found that "few blacks speak foreign languages. Now the U.S. diplomatic service may be the only one in the world that does not even consider foreign-language ability when it makes hiring decisions."[15]
- "Enterprise zones" mostly in black neighborhoods. We discover that "the neighborhoods that benefit from this kind of taxpayer largess are almost invariably black."[16]
- Even quotas for the number of blacks in advertising photos. "In 1991, the U. S. Court of Appeals for the Second Circuit ruled that *The New York Times* could be sued because it accepted real-estate ads that did not depict enough nonwhites."[17]
- Lawsuits forcing special treatment. In 1991, even though Northwest Airlines "admitted no discrimination," it settled a case that was brought against it based on allegedly having too-few black employees. The settlement committed the airline to spend $3.5 million to "accelerate the hiring and promotion of blacks. It also agreed to finance scholarships for black trainees and to pay hundreds of thousands of dollars to blacks who claimed discrimination."[18] In countless places of employment, grievances and lawsuits make life unbearable, lower productivity, raise the cost of doing business, and lessen the competitiveness of American business in international trade.
- Racial extortion. Taylor tells how violence and activist intimidation, including even a threat of bloodshed by a black militia (for which "six hundred blacks crowded into a grade school auditori-



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um to sign up") and "urban guerrilla warfare," have been used to extort money.[19]

All of this reflects the idea that preferences for blacks don't count as discrimination. Taylor refers, as an example, to IRS publication 557, which says that "a policy of a school that favors racial minority groups...does not constitute discrimination."[20]

The effects are by no means entirely favorable to blacks, even if their self-destructive fall into dependency isn't considered. Because of the threat of lawsuits and the many other encumbrances that hiring minorities now entails, "employers may have bid up the wages for smart, hardworking, sure-bet blacks, but they may be more hesitant than ever to risk hiring the marginal cases...."[21] In addition, blacks are led to doubt their own abilities; and everyone, black and white alike, is forced to wonder whether a given black's rise to a position of responsibility is due to racial preference rather than to ability, thus placing a heavy mortgage on black achievement.

A surprising feature pointed out by Taylor is that affirmative action has even been extended to recent immigrants – provided they aren't white (which 90 percent of them now are not). He cites the astounding fact that the California Highway Department "has advertised job vacancies *in Mexico* in the hope of meeting affirmative action goals for Hispanics."[22]

**Discussion of Specific Episodes and Issues**

Taylor's documentation provides a handy reference source about episodes and issues that have captured public attention. These include the cases of Tawana Brawley, the Central Park jogger, Rodney King, Reginald Denny, and the incidents at Howard Beach, Bensonhurst and Crown Heights. Specifics are given about issues such as school busing, alleged anti-black "test bias," and the gerrymandering of Congressional districts through a distortion of the Voting Rights Act of 1965.

**Discussion of Court Decisions**

It would have been useful for Taylor to have included an appendix giving a chronology of legislation, court decisions and agency regulations, but he instead wove these into his narrative. Of particular value is his discussion of the concept of "disparate impact," which places under scrutiny even an impartial standard, as used, say,



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by an employer, if the standard affects races differently. Taylor quotes a legal manual used by fire departments which says that, according to the EEOC, veterans applying for jobs can't be asked whether they have an honorable discharge. "The reason is," the manual states, "that twice as many blacks receive dishonorable discharges as whites." After the U. S. Supreme Court shifted the burden of proof to call upon someone who has challenged a standard to show it was unfair, Congress attempted to override the Court with its Civil Rights Act of 1990, which was at first vetoed by President Bush but was signed by him in the next year's version.[23]

**The Ideological Aspect: Fantasies, Shibboleths, Taboos and Double Standards**

The many acts of racial preference arise out of, are justified by, and in turn reenforce a complex system of ideology and myth. Anyone who seeks to understand the fix the United States is in must come to grips with this miasma of ideology. Taylor's book is again an excellent source.

- The beginning premise is that there exists a ubiquitous white racism. Every actual expression of racism, together with every straw that would appear to support this thesis, is seized upon; and often the wildest charges are made about it, as in the Tawana Brawley case.
- From this, it is an easy step to asserting that whites are responsible for all the problems blacks face, which Taylor says becomes the central premise behind the system of compensatory preferences.
- This premise is replete with implications and consequences. It tells blacks that they can't help themselves and that they must accordingly look to whites for help in all aspects of their lives; it becomes the basis for excusing failure and for special treatment; it directs attention away from root-cause moral deficiencies; and it even goes so far as to argue that to hold people responsible for their behavior is to "blame the victim." With this as context, we are reminded of Herrnstein and Murray's thesis in *The Bell Curve*: Taylor says that "if whites are not holding blacks down, it might mean that they have risen as far as their inherent limitations permit. The possibility of black inferiority is the unacknowledged goblin that lurks in the background of every attempt to explain black failure."[24]

The more society's experience suggests that possibility, the more hysterical becomes the ideology of blaming whites. The premise is



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trumpeted with authoritarian righteousness. For the most part, whites cower in the face of it, becoming ever more intimidated and acquiescent. At the same time, they become steeped in cynicism, hypocrisy, and privately voiced opinions. Those who speak up publicly, telling what everyone knows, are severely punished so that others will know better than to do the same.

• There are a number of subordinate myths. One is that blacks simply commit one type of crime while whites commit just as much crime, but of a white-collar variety. Taylor pierces this with a few facts: "Blacks commit a disproportionate number of white-collar offenses as well. In 1990, blacks were nearly three times as likely as whites to be arrested for forgery, counterfeiting, and embezzlement, and were 3.4 times more likely to be arrested for receiving stolen property."[25]

Another is that blacks don't receive their share of kidney transplants. Again, facts shed light: "First of all, organ transplants work best between people of the same race; one fifth of blacks have antigens that make them reject kidneys donated by whites. At the same time, blacks are only half as likely as whites to donate organs after they die...."[26]

Yet another is that white cab drivers refuse to pick up blacks as passengers. Taylor reports, though, that "One white New York City driver...points out that in his city as many as seventeen drivers have been murdered by riders in a single year, that hundreds are beaten and wounded, and thousands are robbed or defrauded...Half of New York's cab drivers are themselves black and act no differently from white drivers."[27]

• One of Taylor's more valuable contributions is that he unmasks the vast array of double-standards. Ideology has cast Americans' public discourse into a form of Orwellian "double-speak"; and just as there is a twin-track system of legal rights and obligations, there is a twin-track system of thought. Here briefly are some of the double-standards Taylor documents:

"It has become virtually impossible to criticize a black...without provoking cries of racism." When, for example, black mayors in Atlantic City and Birmingham were charged with corruption, they were cloaked in "the trappings of civil rights martyrdom."[28]

"Diversity" is demanded of predominantly white institutions, but not of black ones.



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"Testers" who look for discrimination by acting as though they want to buy or rent housing are used just to test whites, not to check, as well, for biased conduct on the part of minorities.

Sensitivity in the use of language is demanded of whites, but blacks are unrestrained in the use of racial slurs. (We are reminded of how the media a few years ago went out of its way to coin the acronym "WASP" for "white anglo-saxon protestant.")

The news is slanted to put minorities in the best possible light. "The eighty-eight daily newspapers of the Gannett chain are under strict orders to look for articles and photographs that show minorities in a favorable light...Every day, [*USA Today*] runs four photographs on the top half of page one. At least one photograph must be of an ethnic minority."[29]

Drama, television and movies are similarly skewed. "Blacks are almost never chosen as bad guys. Instead, it is white businessmen...." In supposedly non-fiction accounts, such as the film "Glory," facts are distorted, omitted, made up, or falsified.[30]

Even though Martin Luther King, Jr.'s, plagiarism of his doctoral dissertation has been extensively documented, this is universally ignored. The life of Malcolm X is also distorted to make it more palatable.

Black caucuses and special groups are permitted, whereas they would be taboo for whites. There is a Miss Black America beauty pageant, and universities recognize black fraternities and sororities while coming down hard on any racial criterion for admission within the traditional Greek system. There are black student newspapers. And "most black giving goes to explicitly racial organizations," whereas "a specifically white charity could probably not get tax-exempt status."[31]

Blacks engage in overwhelming bloc voting for Democrats and for black candidates. If whites did the same thing, it would be condemned as deeply racist.

The argument is made that "only whites can be racist."

A number of places have outlawed "hate crimes," but this concept is applied with a double standard. A crime by a white against a black is presumed to be racially motivated; no such presumption is made about the extensive crime committed by blacks against whites.

"One of the most spectacular examples of our racial double standards is the way we treat Africa." American public opinion



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condemned the white regimes of Rhodesia and South Africa, but "we hardly notice the far worse abuses of black governments." Sixty-nine people were killed by physically threatened South African police in the 1960 Sharpeville Massacre, and the world has made it an unforgettable incident; but Taylor points out that when in 1972 the Tutsi army in Rwanda killed 100,000 Hutu, western opinion ignored it (as, we might add, it very largely has with the much larger Rwandan slaughter of 1994).[32]

These double standards are fed by an on-going bias in the media and in academia, and are pressed upon Americans by activist foundations. One example given by Taylor: "In 1989 the *Atlanta Journal and Constitution* published a major, multipage story on criminal sentencing in the state of Georgia...Blacks were twice as likely as whites to go to jail for the same crimes...Only forty-six inches into the story did it become clear that the newspaper's data ignored prior convictions."[33]

**Taylor's Proposed Solutions**

Needless to say, an important part of the solution for Taylor is to clear up the intellectual, moral fog so that Americans can look at racial matters truthfully. "There can be no cure without a correct diagnosis." This means piercing the generalization that white racism is rampant in today's society and the premise that whites are responsible for all of blacks' problems. It means placing responsibility on those who commit anti-social acts; and it means abolishing the double standards.

In a final chapter entitled "What Is to be Done?," Taylor is surprisingly brief about policy prescriptions, since he thinks that most current policy can only be changed after a hard-won change in attitudes. This realism causes him to focus almost entirely on a specific and relatively simple solution to the problem that is central to the plight of the underclass, which is that of "reproductive responsibility." He says that "reckless procreation lies at the heart of the rot." Since "in our current moral climate, telling them not to have sex will not work" and Americans will not accept something as "extreme" as the mandatory sterilization of welfare recipients, he sees potential in the Norplant contraceptive. "Late in 1990, the FDA approved a five-year, implantable contraceptive known as Norplant ... Welfare recipients could be required to use Norplant ... and to



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continue using it for as long as they were on the dole," he says. "A Norplant program will seem obvious to many, radical to some. Those who would find it radical should bear in mind that it would be a return to one of the simplest and most obvious rules by which healthy societies have always lived: People should not have children they cannot support. There is scarcely a social problem that would not recede dramatically if Americans once more began to live by this rule."[34]

**A Few Criticisms**

The book is valuable on all of the matters we have covered. There are other matters that it might have gotten into, however, and did not. Taylor mentions the welfare-civil rights apparatus, which of course has become a major pressure group. A chapter on its size, structure, funding, and activities would have added an important dimension. We notice, too, that he did not get into any of the detail about black IQ, other than a brief mention on page 106. Were he writing today, after the appearance of more than one book on that subject, including Richard Herrnstein and Charles Murray's *The Bell Curve*, it would be a serious omission. And it would be helpful to have the results of an empirical study calculating the costs to the American economy of the lowering of standards. Such a cost study remains to be done by, say, an econometrician.

A more important criticism is that Taylor, despite his courage and independence of mind, allows himself to accept, uncritically I would assume, some ideas from the American Left. One of these appears when he refers back a generation to "the McCarthy era" and "reckless charges of Communism." In another place, he speaks of Japanese-Americans having been sent to "concentration camps" during World War II. This means he accepts at face value the anti-white mythology that has been spun about the evacuation of Japanese-Americans from the west coast during that war. It is likely that if Taylor made as exhaustive a study of these issues as he has of today's shibboleths on racial matters, he would throw aside these notions just as readily as he does the myths and double-standards we reviewed above. The tendency of contemporary conservative authors to accept earlier views of the Left is unfortunate, but is all-too-common today. Nevertheless, *Paved With Good Intentions: The Failure of Race Relations in Contemporary America* deserves to be on every thoughtful American's



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desk. As events unfold, its important becomes even more obviously important than it was when the book was first published in 1992.

**Endnotes**

1. R. A. J. Walling, ed., *The Diaries of John Bright* (New York: William Morrow and Company, 1931), pp. 21, 41.
2. Taylor, *Paved With Good Intentions* (the book under review), p. 163.
3. Ibid, p. 11.
4. Ibid, pp. 92-93.
5. Ibid, p. 82.
6. Ibid, p. 11.
7. Ibid, pp. 311-312.
8. Ibid, p. 11.
9. Ibid, pp. 11, 178, 197-198.
10. Ibid, p. 257.
11. Ibid, p. 126.
12. Ibid, pp. 139, 151.
13. Ibid, pp. 161, 185-186.
14. Ibid, pp. 152, 158-159.
15. Ibid, p. 152.
16. Ibid, p. 187.
17. Ibid, p. 190.
18. Ibid, p. 151.
19. Ibid, p. 201.
20. Ibid, p. 172.
21. Ibid, p. 211.
22. Ibid, p. 197.
23. Ibid, pp. 142-147.
24. Ibid, p. 106.
25. Ibid, p. 37.
26. Ibid, p. 59.
27. Ibid, p. 58.
28. Ibid, pp. 66, 67.
29. Ibid, p. 223.
30. Ibid, pp. 229-231.
31. Ibid, p. 251.
32. Ibid, pp. 275-276.
33. Ibid, p. 41.
34. Ibid, pp. 348-352.



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*Editor: Humphrey Dalton*

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*BOOK REVIEW ARTICLE*

# Conflict in the U.S. Intelligence Services

Robert H. Riefe
*Security Analyst, Washington D.C.*

**Wedge, the Secret War between the FBI and CIA**
*Mark Riebling*
Alfred A. Knopf, 1994, New York, 563 pages, $27.50, hardback.

Now that yet another CIA director has been instructed to spell out a post Cold War mission for that organization as well as to tighten up security within it, it is worthwhile to review the history of American intelligence over the past half century. A detailed study of the role of CIA is of particular importance since some members of Congress have recently expressed forceful opinions about the future of the Agency. Senator Daniel Patrick Moynihan, for example, has urged that CIA be scrubbed on the alleged grounds that it failed to predict the collapse of the USSR. More temperate legislators have recommended folding elements of CIA into the State and Defense Departments. The biggest single issue seems to relate to the future of the clandestine service, the Deputy Directorate of Operations (DDO). It is understandable that Congressional criticism which invariably accompanies an intelligence failure would grow deafening in the wake of the exposure of Aldrich Ames for passing sensitive information to the Soviets for almost a decade which resulted in the deaths of some dozen CIA sources operating within the Soviet military and intelligence establishments and the virtual destruction of the program to ferret out Soviet secrets.

Although the Ames' affair has proved to be the Agency's single worst counterintelligence (CI) failure, it was preceded by an extended series of flaps, some of which resulted from the betrayal of trust by staff personnel but many more as a consequence of inadequate vetting and validation of alleged assets by members of the DDO.

The history of counterintelligence has now been told in the kind of detail that should be mandatory reading for the new director



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and his aides. Counterintelligence is designed to protect the secrets of an intelligence organization and the government itself by preventing an enemy from recruiting staff personnel or insinuating agents into the organization. CI is also responsible for frustrating efforts by technical means to penetrate the organization and its channels of communication.

*Wedge* is the product of careful research and analysis by Mark Riebling, a journalist with a deservedly excellent reputation. It is in the broadest sense a history of American counterintelligence from World War II to mid-1994. In it Riebling makes a strong case that much of what has gone wrong has been the result of a decision by President Franklin D. Roosevelt in June 1941 to divide the dual functions of collecting intelligence and carrying out CI responsibilities between the FBI and the newly organized Coordinator of Intelligence at the waterline. The FBI under Director J. Edgar Hoover was to be responsible for both activities within the country; the COI headed by General William Donovan was to carry out its tasks abroad. This operational division persisted through various organizational permutations and was inscribed in the CIA charter in 1947. The resultant "wedge," the split in jurisdictions, according to the author, has permitted our enemies ever since to take advantage of the system by shifting their clandestine activities back and forth between the U.S. and abroad so as to avoid detection, knowing that effective coordination between the two American agencies was sometimes poor and was occasionally absent altogether. Had there not been such a wedge, Riebling asserts, the Bureau would have been assigned the Ames' investigation much sooner than was the case despite the fact that he was a CIA staff officer.

Riebling argues that the original separation of jurisdictions was made for bureaucratic and political reasons and not for constitutional ones. It is true that the wartime relationship between Hoover and Donovan was marked by suspicion and hostility. Both principals had supporters in Congress which gave the struggle decidedly political overtones. Yet objections on constitutional grounds to every suggestion to merge domestic and foreign functions in one superagency were heard early on and persist to this day. In fact, Roosevelt had simply followed the pattern set by other Western democracies, notably those of Britain and France, in creating separate agencies responsible for domestic and foreign coverage.



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Nor is this a propitious time for proponents of a merger to advance the old argument that it will necessarily advance efficiency. If such a reorganization was not achieved during the Cold War when East and West were locked in a struggle with implications for the entire world, it is unlikely that an American administration would seriously entertain the idea today. Accordingly it is highly unlikely that a superagency will emerge from the welter of proposals accompanying the current effort to the structure and functions of federal departments and agencies including those of the intelligence community.

Riebling is correct in asserting that a number of intelligence failures over the past half century were the product of ineffectual or non-existent coordination between the FBI and CIA beginning perhaps with the Venona case in the early 1950s. The failure of the FBI to inform the CIA about material gleaned from a technical operation against the Soviets contributed to the failure by the CIA to unmask Kim Philby and by extension his allies in the infamous Cambridge network of traitors at a time when the British services, MI-5 and MI-6, were reluctant to investigate their own personnel. During the early years of CIA, Director Hoover of the FBI was understandably concerned that the new organization was a leaky vessel into which to pour secrets. A number of suspect Communists, other political extremists and assorted eccentrics had made the transition from OSS to CIA. What further exacerbated Hoover's suspicions was his wartime experience with Donovan, a man who had paid little attention to security procedures and who had left his mark on the new peacetime organization. If all of that were not enough , the head of the Bureau was bound to be hostile to CIA because he viewed it as a rival competing with the FBI for money, prestige and influence with the Congress.

Even when a measure of cooperation was achieved failures occurred. A faulty FBI surveillance of Pyotr Popov, an officer in Soviet military intelligence and for years the Agency's most valuable asset, probably resulted in the failure of the operation and the death @f the agent. Blame for such lapses however can be assigned to both services. After the disastrous Bay of Pigs operation in Cuba the Agency was directed by Bobby Kennedy to get rid of Fidel Castro. As a result of this order, which for obvious reasons was never made a part of the official record, CIA became involved with the Mafia



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because it was connected in Havana with people having direct access to the Cuban dictator. Despite the fact that the Bureau had an extended history of operations against organized crime and knew the principals with whom the Agency was in touch, the FBI was never informed of the operation possibly because the Attorney General had sworn the CIA officials in charge to secrecy. It can be presumed that Hoover might well have persuaded the administration that the CIA was playing a dangerous game with people who were unlikely to be discreet or responsive. What we now know is that Castro was aware of the plotting almost from the outset.

There followed an extended period of squabBling over the reliability of Soviet agents, some of whom had been recruited abroad by the CIA, the others by the FBI operating against the Soviet Embassy in Washington and its Mission to the U.N. in New York. There was not only a disinclination on the part of each organization to believe that the other had recruited a bona fide agent, but there were serious failures to cooperate in operation! of significance to the policy makers. In fact the Warren Commission investigating the assassination of President Kennedy was severely critical of the FBI for its failure to cooperate in the case of Yuri Nosenko, a KGB officer who had defected to the CIA and who purported to have firs@ hand information on Lee Harvey Oswald during his sojourn in the Soviet Union.

Along with failures in Soviet cases per se, there were problems stemming from a decision by the CIA not to inform the FBI let alone to coordinate with it on a program to collect intelligence within the country on U.S. radicals who were suspected of having secret connections with foreign intelligence services. Riebling suggests that this lapse plus the inability of either organization to provide positive information on the subject led to a decision by the White House to set up the Watergate plumbers in June 1971. Given the pervasive sense of paranoia that gripped the upper level of the Nixon administration by that time, it is true that the president had lost all confidence that either organization would produce the desired information.

Within the CIA the Counterintelligence (CI) Staff had traditionally been responsible for vetting agent candidates and authenticating assets recruited by the several geographic divisions of the DDO as well as carrying out a liaison relation- ship with the FBI.



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Members of the staff were responsible for providing a detailed and disinterested analysis of each asset which frequently put them at odds with the people directly responsible who were more likely to take a positive if not a rosy view of the reliability and loyalty of an agent. Such a system inevitably created tensions between staff and division although the ensuing give and take often proved to be a constructive process. The long term chief of the staff in the 1960s was James Jesus Angleton, orchid grower, poet and veteran of the OSS. By the latter part of the decade; had become thoroughly negative about a number of would-be agents being run by the Soviet Division. His suspicion of their untrustworthiness bordered on paranoia, a state of mind which is understandable in any person exercising such a function for an extended period of time.

In June 1971 Richard Helms was fired as director of CIA, principally because he had refused to let the White House use the CIA in an attempt to cover up Watergate. He was replaced by James Schlesinger who in turn was succeeded by William Colby less than two years later. The latter, a long time nemesis of Angleton's with little understanding of or sympathy for counterintelligence, decreed that thereafter every recruiter and agent handler would be responsible for the CI aspects of his own cases, a decision which neatly cut the ground out from under the CI Staff. It soon proved to be an impossible task to impose on an officer in the field. The new director also took-away the function of liaison with the FBI from the staff and gave it to the geographical divisions. Finally when Angleton continued to resist what he correctly deemed to be the emasculation of the staff function, Colby leaked sensitive information to the press on the role of the staff in collecting intelligence on American radicals. This final blow forced Angleton to resign, He was replaced by George Kalaris who declared that much of what the staff had been doing was worthless. Kalaris' deputy Leonard McCoy destroyed the bulk of the files without a serious effort to undertake a review of them.

The overnight demise of @he Counterintelligence Staff meant that every geographical component was now responsible for validating its own assets. The result, as we later learned, was the wholesale acquisition of alleged agents who were in actuality wholly controlled by the Soviet services or those of its allies. The most egregious example was the purported recruitment as CIA agents of dozens of Cuban officials, all but one of whom proved in the long run to have



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been sent by Castro's intelligence services. Before the truth became known promotions and awards were bestowed on officers responsible for the presumed accomplishments. Save for one midlevel officer who sought in vain to raise serious questions about the bona fides of the recruits (sic), there was no one present to blow a whistle on such self-serving activity. Later after the whole house of cards came tumbling down, the beneficiaries who had moved up the bureaucratic ladder were not held responsible for what can only be termed slipshod activity. The individual who had sought to raise a danger signal was merely sent a letter of apology for having been ignored. He had long since retired, a prophet without honor.

It wasn't until William Casey was installed as director in 1981 that primary responsibility for counterintelligence was once again centered in the CI Staff. Much damage had been done in the intervening years. Riebling's review of what properly could be called the war within the CIA is richly detailed and is for the most part accurate. In fact his coverage of this period indicates that the war within had proved more costly than the "war" without, the struggle between the FBI and CIA which subsided to a large extent after the death of Hoover in May 1973. There is little doubt that Aldrich Ames exploited the wedge within the Agency to the fullest.

In the past few years counterintelligence within the Agency has been significantly strengthened. However this fact can not preclude treachery by another Aldrich Ames. Staff officers will always be in a position to do great damage if they choose to .violate their solemn oaths. They must be selected with far greater care than has traditionally been the case.

In the meantime cooperation and coordination between the FBI and CIA is probably better than it has ever been. There will continue to be differences between the two organizations and tensions will develop from time to time as should be expected in any bureaucracy. But the old hostility has gone and, we trust, will not return.

The lessons that emerge from the Riebling book are plain.

1. Counterintelligence will continue to be a function of both the FBI and CIA as well as of the intelligence agencies within the military services. The present level of cooperation ought to be maintained.

2. Within CIA there must continue to be a strong and independent component with the responsibility to review the ongoing



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operations of the geographical divisions and the authority to call a halt to any activity that does not meet the agreed upon security criteria.

3. Officers responsible for shoddy and self-serving work in the recruitment and management of sources should be penalized just as they are rewarded for their accomplishments.

Mark Riebling's study points to these conclusions even while he maintains that most the counterintelligence flaps have derived from rivalry between the FBI and CIA. The new CIA management can hope to ensure that differences between division and staff will be ironed out as the result of constructive dialogue. The CIA can never again be permitted to lapse as it did at Langley in the 1970s.

Regardless of the reviewer's skepticism regarding Riebling's emphasis and proposals, the undersigned can enthusiastically endorse this work for any student of intelligence and public policy. It is a "must read" for every intelligence officer.



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